No. 15887

United States
Court of Appeals
For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

BELRIDGE OIL COMPANY,

Respondent.

Transcript of Record

Petition to Review a Decision of the Tax Court of the United States

Phillips & Van Ordon Co., 4th & Berry, San Francisco, Calif.—3-28-58

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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APPEARANCES

For Petitioner:

JOHN B. MILLIKEN, ESQ.,
RALPH KOHLMEIER, ESQ.,
FRANK W. CLARK, JR., ESQ.,
HARRISON HARKINS, ESQ.,
L. A. LUCE, ESQ.

For Respondent:

RICHARD W. JANES, ESQ.

The Tax Court of the United States

Docket No. 54288

BELRIDGE OIL COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES

1954

Aug. 18—Petition received and filed. Taxpayer notified. Fee paid.

Aug. 18—Copy of petition served on General Counsel.

Oct. 5—Answer filed by General Counsel.

Oct. 5—Request for hearing in Los Angeles filed by General Counsel.

Oct. 7—Notice issued placing proceeding on Los Angeles calendar.
Service of answer and request made.

1955

Oct. 25—Hearing set Jan. 30, 1956, L.A.

1956

Feb. 1—Hearing had before Judge Rice on merits. Stipulation of facts, with exhibits 1-A thru 7-G filed. Petrs. brief 4/2/56; respondent's brief, 5/17/56; reply 6/18/56.

Feb. 17—Transcript of Hearing 2/1/56, filed.

1956

Apr. 2—Motion for extension to May 11, 1956, to file brief filed by petr. 4/2/56, granted.

May 15—Brief filed by petitioner. 5/15/56, served.

June 22—Motion for extension of time to 8/9/56, to file brief filed by respondent. Granted 6/26/56. Served 6/28/56.

Aug. 6—Motion for extension of time to 9/7/56, to file brief filed by respondent. 8/7/56, granted. Served 8/8/56.

Sept. 7—Respondent's Brief in answer filed. 9/10/56, served.

Oct. 5—Motion for extension of time to Nov. 1, 1956, to file reply brief filed by petr. 10/5/56, granted.

Oct. 9—Oct. 5 motion served.

Oct. 29—Reply Brief filed by petitioner. 10/29/56, served.

1957

Mar. 29—Findings of fact and opinion filed. Rice J. Decision will be entered under Rule 50. Served 3/29/57.

July 24—Agreed computation filed.

July 26—Decision entered, Murdock J. Div. 3. Served 7/29/57.

Oct. 18—Petition for review by U. S. Court of Appeals, 9th, filed by respondent.

Oct. 29—Proof of service of petition for review on L. O. Hopkins filed.

Oct. 29—Proof of service of petition for review on John B. Milliken, Esq., filed.

1957

Nov. 15—Motion by respondent for extension of time for filing record on review and docketing pet. for review to Jan. 16, 1958.

Nov. 15—Order extending time for filing record on review and docketing pet. for review to Jan. 16, 1958.

Dec. 16—Designation of contents of record on review with proof of service thereon filed by resp.

Dec. 16—Statement of points to be relied upon filed by resp., with proof of service thereon.

Dec. 27—Proof of service of statement of points filed.

Dec. 27—Proof of service of Designation of Contents of Record on review filed.

[Title of Tax Court and Cause.]

PETITION FOR A REDETERMINATION OF INCOME AND EXCESS PROFITS TAX DEFICIENCY AND FOR REFUND

Belridge Oil Company, the petitioner, hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (bureau symbols A:R:90D:LHP) dated May 28, 1954, and for a determination of refund of taxes, and as a basis of its proceeding the petitioner alleges as follows:

I.

The petitioner is a corporation, duly organized and existing under the laws of the State of California, with its principal office at 815 Edison Building, 601 West Fifth Street, Los Angeles 17, California; and it filed its tax return for the calendar year 1950, the taxable year at issue, with the Director of Internal Revenue for the Los Angeles, California, District.

II.

The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on May 28, 1954, the date that it bears. Attached hereto and marked Exhibit A-1 are excerpts from the "report of examination dated March 12, 1954," referred to in the Statement accompanying the notice of deficiency, which excerpts are material to the issues set out in the assignments of error and are necessary to elucidate the determination of the deficiency and the refund which are in controversy.

III.

The deficiency determined by the Commissioner involves income and excess profits taxes for the calendar taxable year 1950 in the amount of $43,746.32, and although not all of the Commissioner's adjustments are at issue, the entire dollar amount of the deficiency is in controversy and, in addition, the petitioner claims a refund in the amount of $8,248.56, or such other amounts as the Court may determine.

IV.

The determination of tax set forth in the notice of deficiency is based on the following errors:

(a) The Commissioner erred in disallowing depletion deductions in the amount of $56,888.79 (or in any amount) with respect to the deductions for depletion on oil and gas wells claimed by the petitioner on its tax return, and allowable under the provisions of sections 23(m) and 114(b)(3) of the Internal Revenue Code.

(b) The Commissioner erred in his determination that the amount of the depletion deduction on oil and gas wells allowable to the petitioner under section 23(m) of the Internal Revenue Code is limited to $1,583,784.77.

(c) The Commissioner erred in not determining that the amount of the depletion deduction on oil and gas wells allowable to the petitioner under sections 23(m) and 114(b)(3) of the Internal Revenue Code is at least $1,674,806.98, an amount which is $34,133.42 in excess of the aggregate depletion deduction claimed by the petitioner on its return for the year at issue.

(d) The Commissioner erred in not determining that the petitioner is entitled to a refund of income and excess profits taxes for the year at issue in the amount of at least $8,248.56.

V.

The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) The petitioner is engaged principally in the business of producing oil and gas from lands located in Kern County, California. All of the lands hereinafter referred to are located in Kern County, California.

(b) In 1911 the petitioner acquired ownership in fee of some 30,845.96 acres of land (hereinafter called the "Main Property"), and over a period of years two separate producing fields were developed on the Main Property and are known as the North Belridge field and the South Belridge field, respectively.

(c) Prior to 1930 all production obtained from the North Belridge field was from relatively shallow wells (hereinafter sometimes called the "Shallow Zone"), but during the years 1930 to 1942, inclusive, four deeper producing zones underlying the North Belridge field were developed, in addition to the Shallow Zone, as follows:

Zone	Approximate Depth	Year initial wells completed
Temblor Zone	6,000 feet	1930
64 Zone	8,000 feet	1932
R. Zone	7,000 feet	1939
Y. Zone	9,000 feet	1942

The 64 Zone is sometimes called the Wagon Wheel Zone.

(d) In 1945 the petitioner acquired by purchase a producing property, known as the Result property, consisting of approximately 80 acres of land adja-

cent to the petitioner's land in the North Belridge field. Several wells producing from the 64 Zone were on the property when acquired. The Temblor Zone also extends under the Result property.

(e) The 64 Zone does not underlie all of the petitioner's land in the North Belridge area (much less all of its Main Property), but to the extent it does underlie the petitioner's land in the North Belridge area the 64 Zone is the largest developed oil and gas reservoir under such land, and this zone also extends, to some extent, under properties in the North Belridge field owned or operated by five other oil companies, namely, Tide Water Associated Oil Company, Richfield Oil Corporation, The Texas Company, Standard Oil Company of California and Union Oil Company of California.

(f) Prior to October of 1941, production from the 64 Zone by the petitioner and the other oil companies producing from the zone was strictly on a competitive basis. By the year 1938 total oil production from the 64 Zone reached approximately 12,000 barrels a day, but subsequent to 1938 oil production from the zone declined steadily as did the reservoir pressure.

(g) The 64 Zone consists of an elongated dome with a large gas cap circled by a black oil belt which, in turn, is surrounded by water from which a very effective water drive is developed. The gas cap is located principally under the land of the petitioner, and oil can be moved up or down structure from the

petitioner's land by lessening or increasing the gas cap pressure, as the case may be.

(h) Over the period October, 1941 to April 1, 1947, a voluntary gas pressure maintenance program was put in effect by the companies producing from the 64 Zone and a portion of the gas produced with oil from the zone was returned to the reservoir.

(i) In April of 1947, the six companies producing from the 64 Zone abandoned the program of voluntary pressure maintenance and returned to a basis of unrestricted competitive production until February 1, 1950. During this period the six companies obtained approximately the same percentage of total production from the 64 Zone as the "Participating Equities" allotted to them under the "Unit Agreement" hereinafter described.

(j) Prior to February 1, 1950 (but effective on that date) the petitioner and the five other oil companies producing from the 64 Zone, as well as some, but not all, of the owners of royalty interests in the zone, agreed to a plan of production from the 64 Zone on a co-operative basis under that certain agreement entitled "Unit Agreement for the 64 Zone of the North Belridge Oil and Gas Field, Kern County, California," (herein sometimes called the "Unit Agreement") which became effective February 1, 1950, and is to continue as long as production can be obtained from the 64 Zone in quantities determined by the Participants to be sufficient to pay to produce, or until terminated prior to such time by the unanimous consent of the Participants.

(k) The initial "Participants" in the unit operations and their respective "Participating Equities" were as follows:

Participant	Participating Equity
Petitioner	71.87%
Tide Water Associated Oil Company	16.58%
Richfield Oil Corporation	4.44%
The Texas Company	4.44%
Standard Oil Company of California	1.48%
Union Oil Company of California	1.19%
	100.00%

The Unit Agreement defined the term "Participating Equity" to mean that percentage which is the share of the "Unitized Substances" allocated under the agreement to each respective Participant; and the term "Unitized Substances" was defined to mean all oil, gas and associated hydrocarbons produced and saved from the 64 Zone pursuant to the Unit Agreement.

(l) The petitioner was designated as the original Operator under the Unit Agreement and has continued to act as such, and the agreement states the intention of each Participant to establish the Operator as its agent under the agreement for the sole purpose of developing, operating and protecting its interest in the 64 Zone to the extent set forth in the agreement; and the Unit Agreement provides that

the Operator, at the effective date of the agreement, shall take exclusive possession of the operating rights of each Participant in and to the 64 Zone, and enter into the performance of its duties under the agreement to the end that the 64 Zone shall be operated as a unit by a single operator for the benefit of the Participants. The agreement reserves to each Participant whatever rights the Participant may have to develop and produce oil, gas and associated hydrocarbons from any and all formations, zones, or strata other than the 64 Zone, and to use and occupy its land in the area for all purposes not inconsistent with the Unit Agreement.

(m) The Unit Agreement provides that each Participant shall own the percentage of Unitized Substances equal to the Participating Equity of such Participant, and shall accept and take in kind its Participating Equity share of crude oil and wet gas produced and saved from the 64 Zone.

(n) The portions of the petitioner's two properties affected by the Unit Agreement were the 64 Zone underlying the Result property, and the 64 Zone underlying some, but not all, of its Main Property, which latter portion will be hereinafter called the "64 Zone Unitized Area of the Main Property." The Unit Agreement did not affect the other zones underlying the land of the Petitioner, including the Temblor Zone of the Result property, nor the Shallow, Temblor, R. and Y zones underlying the 64 Zone Unitized Area of the Main Property.

(o) The petitioner did not dispose of, sell or exchange with the Operator, or the Participants, or any or all of them, or with any person, any mineral deposit or interest therein, by virtue of its execution of the Unit Agreement or its participation in the unit operation under the agreement.

(p) Both before and after the effective date of the Unit Agreement and operations thereunder, the petitioner owned and continued to own the mineral deposits and all economic interests therein, in the 64 Zone underlying the Result property and in the 64 Zone underlying the 64 Zone Unitized Area of the Main Property.

(q) In the years prior to the year at issue the petitioner and the Commissioner consistently have treated the Main Property (as hereinabove described) as a single property for depletion purposes; and depletion applicable to oil and gas produced from the Main Property (that is, including the petitioner's land in the North and South Belridge fields, and the several producing zones in said fields) has been computed, deducted and allowed on the basis of the adjusted March 1, 1913, value or the statutory percentage of income, whichever was applicable in the tax year involved.

(r) In years prior to the year at issue, the petitioner and the Commissioner consistently have treated the Result property as a separate property apart from the Main Property; and depletion applicable to production from the Result property

(that is, from the several zones underlying it) has been computed, deducted and allowed on the basis of adjusted cost or the statutory percentage of income, whichever was applicable. Depletion based on adjusted cost has consistently been greater than depletion based on the statutory percentage of income.

(s) In its tax return for the year at issue, the petitioner (consistent with past accepted practice) treated the Main Property as a single property for depletion purposes, and computed and deducted depletion applicable to the property on the basis of the statutory percentage of income and in the amount of $1,568,662.93; that is, on the basis of 27½% of $5,704,228.85, the gross income from the Main Property. The depletion claimed by the petitioner on the Main Property is less than 50% of the net income of the petitioner (computed without allowance for depletion) from the Main Property.

(t) In its tax return for the year at issue, the petitioner (consistent with past accepted practice) treated the Result property as a separate property for depletion purposes, and computed and deducted depletion applicable to the property on the basis of adjusted cost and in the amount of $72,010.63, based on a cost depletion unit of $3.43035 a barrel and production in the amount of 20,992.21 barrels of oil.

(u) In the year at issue the adjusted basis of the Result property was $1,016,863.10; the number of units of mineral remaining as of the taxable year was 201,106 barrels; the cost depletion unit was

$5.056354 a barrel; the production for the year was 20,992.21 barrels; and the allowable cost depletion was $106,144.05 rather than the amount of $72,010.63 claimed on the return, or the amount of $16,690.52 allowed by the Commissioner.

(v) Over the objections of the petitioner the Commissioner has determined that by virtue of the Unit Agreement, and on its effective date (February 1, 1950), the petitioner made nontaxable exchanges of its separate interests in the 64 Zone underlying the area covered by the Unit Agreement, for a single and separate depletable interest (consisting of an undivided interest in the amount of 71.87%) in the properties covered by the Unit Agreement, including the petitioner's own portions of the 64 Zone underlying its Main Property and its Result property, and that the basis to the petitioner for said undivided interest is the combined adjusted bases of its separate interests in the 64 Zone underlying the area covered by the Unit Agreement.

(w) In his determination of deficiency, the Commissioner has revised the petitioner's computation of percentage depletion on its Main Property by excluding from the Main Property the 64 Zone Unitized Area of the Main Property, and the Commissioner has treated the remainder of the Main Property (including the petitioner's land in the North and South Belridge fields, and the several producing zones, other than the 64 Zone, underlying said land) as a separate property for the purpose of computing the percentage depletion allowed by him

with respect to all production from the Main Property other than the 64 Zone Unitized Area of the Main Property.

(x) The effect of the Commissioner's determination in this respect is as follows:

	Gross Income	27½% Depletion
Main Property per return	$5,704,228.85	$1,568,662.93
Less: 64 Zone Unitized Area of Main Property	1,019,045.48	280,237.50
Main Property exclusive of 64 Zone Unitized Area	$4,685,183.37	$1,288,425.43

(y) In his determination of deficiency, the Commissioner has revised the petitioner's computation of cost depletion on the Result property and disallowed $55,320.11 of the cost depletion in the amount of $72,010.63 claimed on the return. In making this determination the Commissioner treated the Result property as a separate property for cost depletion purposes only for the month of January, 1950, and he allowed cost depletion in the amount of $16,690.52 by applying a cost depletion unit of $5.0121667 a barrel to January production in the amount of 3,330 barrels.

(z) In his determination of deficiency, the Commissioner has treated as a single and separate depletable property the entire 64 Zone of the petitioner included in the Unitized Area under the Unit Agreement and has determined allowable depletion in the amount of $278,668.82 as follows:

Gross Income	$1,108,003.19
27½% of gross income	304,700.88
Depletion limited to 50% of net income or	278,668.82

(aa) In his determination of deficiency, the Commissioner has effectively disallowed depletion deductions in the aggregate amount of $56,888.79, which the petitioner had deducted on its return, as follows:

Claimed on return:			
(1)	Percentage depletion on the 64 Zone Unitized Area of Main Property	$280,237.50	
(2)	Cost depletion on Result property	72,010.63	$352,248.13
Allowed by Commissioner:			
(1)	Percentage of net income depletion applicable to Unit Agreement operation	$278,668.82	
(2)	January cost depletion on Result	16,690.52	295,359.34
Depletion disallowed			$ 56,888.79

(bb) The petitioner did not acquire a new economic interest in a separate mineral deposit and property by virtue of the Unit Agreement and the unit operations.

(cc) The petitioner did not sell, exchange or dispose of any part of the mineral deposits underlying its Main Property, nor any economic interest therein, by virtue of the Unit Agreement and the

unit operations; and the petitioner is permitted and required to compute depletion on its Main Property as a single, separate property in accordance with the treatment consistently followed by it in prior years and accepted by the Commissioner for those years.

(dd) The petitioner did not sell, exchange or dispose of any part of the mineral deposits underlying its Result property, nor any economic interest therein, by virtue of the Unit Agreement and the unit operations; and the petitioner is permitted and required to compute depletion on its Result property as a single, separate property in accordance with the treatment consistently followed by it in prior years and accepted by the Commissioner for those years.

(ee) The aggregate of the depletion allowable to the petitioner on its Main Property and its Result property for the year at issue is $1,674,806.98, an amount which is $34,133.42 in excess of the aggregate depletion deducted on its return.

(ff) The Commissioner erred in limiting the allowable depletion to $1,583,784.77.

(gg) Pursuant to an extension of time for filing, the petitioner filed its return for the year at issue on May 5, 1951, and paid income and excess profits taxes in the amount of $1,019,485.40, of which the final installment of $203,897.08 was paid on December 7, 1951.

(hh) On November 2, 1953, the petitioner and the Commissioner executed an agreement, pursuant

to section 276(b) of the Internal Revenue Code, extending to June 30, 1955, the time within which the Commissioner might assess the tax for the year.

(ii) The petitioner overpaid its taxes for the year at issue in the amount of $8,248.56. No refund claim was filed by the petitioner, and no part of the amount overpaid has been paid or credited to the petitioner.

(jj) The taxes overpaid by the petitioner were paid within two years before the execution by the petitioner and the Commissioner of said agreement extending the time within which the Commissioner might assess the tax for the year; and said agreement was executed within three years from the time the tax return was filed by the petitioner.

(kk) The petitioner is entitled to a refund of income and excess profits taxes paid by it for the calendar taxable year 1950 in the amount of $8,248.56.

Wherefore, the petitioner prays that the Court will hear the proceedings and determine under Rule 50——

(1) That there is no deficiency in income and excess profits taxes for the calendar taxable year 1950.

(2) That the petitioner has overpaid its income and excess profits taxes for the year in the amount of $8,248.56 or such other amount as the Court may determine.

(3) That the tax overpaid was paid within two years before the execution by the petitioner and the Commissioner of the agreement pursuant to section 276(b) of the Internal Revenue Code to extend to June 30, 1955, the time within which the Commissioner might assess the tax; and that said agreement was executed within three years from the time the tax return was filed by the petitioner; or otherwise determine that the refund is within the period for refunds.

(4) That the petitioner is entitled to such other and further relief as the Court may deem proper.

Respectfully submitted,

/s/ JOHN B. MILLIKEN,

/s/ RALPH KOHLMEIER,

/s/ FRANK W. CLARK, JR.,

/s/ HARRISON HARKINS,
Counsel for the Petitioner.

Of Counsel:

/s/ L. A. LUCE.

Duly verified.

EXHIBIT A

U. S. Treasury Department
Internal Revenue Service
Chief, Audit Division
P. O. Box 231—Main Office
Los Angeles 53, California

May 28, 1954

District Office of
Director of Internal Revenue

In Replying Refer to:
A:R:90D:LHP
MI. 8111, Ext. 381

Belridge Oil Company,
601 West Fifth Street, Room 815,
Los Angeles 17, California.

Gentlemen:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1950, discloses a deficiency or deficiencies of $43,746.32, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washingon 4, D. C., for a redetermination of the

deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the District Director of Internal Revenue, Audit Division, P. O. Box 231, Main Office, Los Angeles 53, Calif. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is the earlier.

Very truly yours,

T. COLEMAN ANDREWS,
Commissioner;

By /s/ R. A. RIDDELL,
District Director of
Internal Revenue.

Enclosures:
Statement
Form 1276
Agreement Form

Statement

A:R:90D:LHP

Belridge Oil Company
601 West Fifth Street, Room 815
Los Angeles 17, California

Tax Liability for the Taxable Year Ended
December 31, 1950

	Liability	Assessed	Deficiency
Income and excess profits tax	$1,063,231.72	$1,019,485.40	$43,746.32

In making this determination of your income and excess profits tax liability, careful consideration has been given to the report of examination dated March 12, 1954.

A copy of this letter and statement has been mailed to your representative, Mr. John B. Milliken, 650 South Spring Street, Los Angeles 14, California, in accordance with the authority contained in the power of attorney executed by you.

Adjustments to Net Income

	Income Tax Net Income	Excess Profits Net Income
Net income as disclosed by return	$2,252,950.65	$2,191,291.14
Additional income and unallowable deductions:		
(a) Capital gain	41,834.53	—
(b) Depletion	56,888.79	56,888.79
(c) State franchise tax	2,709.87	2,709.87
Total	$2,354,383.84	$2,250,889.80
Additional deductions:		
(d) Depreciation	3,834.83	3,834.83
Net income adjusted	$2,350,549.01	$2,247,054.97

Explanation of Adjustments

(a) In your return you have treated the amount received as cash equalization payments under a certain Unit Agreement for the 64 Zone as a reduction of the basis of the assets transferred

to the Operator under the said agreement. It is held that such amount, or $41,834.53, constitutes a capital gain within the meaning of sections 112(c)(1) and 117(j) of the Internal Revenue Code and it is accordingly added to the income reported in your return.

(b) The amount of depletion allowable under section 23(m) of the Internal Revenue Code has been determined to be $1,583,-784.77. Since you claimed in your return a deduction for depletion in the amount of $1,640,673.56 the difference, or $56,888.79, is disallowed.

(c) It has been determined that the deduction allowable for California franchise tax for the taxable year ended December 31, 1950, is the amount of $73,537.83, instead of $76,247.70, the amount deducted in your return. The excess of $2,709.87 is disallowed.

(d) It has been determined that the deduction allowable for depreciation, under section 23(l) of the Internal Revenue Code, is the amount of $163,594.77. Since you claimed in your return a deduction for depreciation in the amount of $159,759.94 the difference, or $3,834.83, is allowed as a deduction.

Computation of Excess Profits Credit

There is determined an excess profits credit, based on invested capital, in the amount of $1,596,765.67, in lieu of $1,606,244.81, the amount claimed in your return, as shown in the following:

Invested capital as disclosed by return		$16,328,060.07
Decrease:		
(a) Equity capital at the beginning of the taxable year		118,489.24
Invested capital, as adjusted		$16,209,570.83
Excess profits credit:		
12% of $5,000,000.00	$ 600,000.00	
10% of $5,000,000.00	500,000.00	
8% of $6,209,570.83	496,765.67	
Excess profits credit, as determined		$ 1,596,765.67

Explanation

(a) Your equity capital at the beginning of the taxable year has been determined in the amount of $16,209,570.83, in lieu of $16,328,060.07, the amount shown by your return, a decrease of $118,489.24.

Computation of Tax

Net income adjusted	$2,350,549.01
Income subject to normal tax and surtax	$2,350,549.01

Computation Under General Rule
(Sections 13 and 15, I.R.C.)

Income tax (combined normal tax and surtax):		
42% of $2,350,549.01	$ 987,230.58	
Subtract	4,750.00	
Total income tax under general rule		$ 982,480.58

Computation of Alternative Tax
(Section 117(c), I.R.C.)

Income as above		$2,350,549.01
Less: Excess of net long-term capital gain over net short-term capital loss		103,494.04
Ordinary net income		$2,247,054.97
Income tax (combined normal tax and surtax):		
42% of $2,247,054.97	$ 943,763.09	
Subtract	4,750.00	
Partial tax		$ 939,013.09
Plus: 25% of $103,494.04		25,873.51
Alternative tax		$ 964,886.60

Tax Under Section 430, I.R.C.

Excess profits net income	$2,247,054.97
Less: Excess profits credit	1,596,765.67
Adjusted excess profits net income	$ 650,289.30
.30% of $650,289.30 (Limitation under Sec. 430(a) (2) not applicable)	$ 195,086.79
Number of days in taxable year	365
Number of days after June 30, 1950	184
Excess profits tax:	
184/365 x $195,086.79	$ 98,345.12
Excess profits tax under section 430	$ 98,345.12

Summary

Income tax (alternative tax)	$ 964,886.60
Excess profits tax	98,345.12
Correct income and excess profits tax liability	$1,063,231.72
Income and excess profits tax assessed:	
Original, account No. 4180941	$1,019,485.40
Deficiency of income and excess profits tax	$ 43,746.32

EXHIBIT A-

Name of Taxpayer Belridge Oil Company

Index:

Date of Report February 24, 1954 MAR 12 1954 19

Examining Officer Walfred E. Runston

STATEMENT OF TOTAL TAX LIABILITY

YEAR	LIABILITY		PREVIOUSLY ASSESSED		ADJUSTMENTS PROPOSED IN THIS REPORT			
					Tax		Penalty	
	Tax	Penalty	Tax	Penalty	Deficiency	Overassessment	Deficiency	Overassessment
				INCOME TAX				
1950	1 063 731.77		1 019 485.40		43 796,37			
TOTAL	1 063 731.77		1 019 485.40		43 796,37			

Belridge Oil Company 1950

PRELIMINARY STATEMENT

The causes of the net deficiency in income taxes recommended herein are due to changes in the allowable depletion arising from Unitization of the North Belridge Oil Field in part; treatment of the cash boot or equilization payments received upon unitization of the aforementioned oil field as a capital gain within the meaning of Section 112(c)(1) of the Internal Revenue Code; changes in the allowable depreciation; and a reduction of the State Franchise Tax accrual.

Belridge Oil Company 1950

Schedule 1(a)

EXPLANATION OF ITEMS

Item (a) Depletion $6 888.79.

Under that certain Unitization Agreement entered into on February 1, 1950 it is recommended herein that a non taxable exchange transpired and that the basis of the interest received in the Unit is the combined basis of the assets so transferred thereto. See Exhibit I for detail analysis and commentary upon this adjustment. herein

EXHIBIT A-1

EXHIBIT I

Los Angeles Division
Engineers Report
March 31, 1952

Belridge Oil Company,
Edison Building,
Los Angeles, California.

Taxable Year 1950

Depletion Denied	$56,888.79
Capital Gain	41,834.53
Additional Depreciation	3,834.83

Discussion of Adjustments

Depletion

The taxpayer, organized in 1911, owns aproximately 30,000 acres in fee simple, located in Kern County, California, and including major portions of both the North and South Belridge Oil Fields.

Deeper horizons known as the "64 Zone" were found in the North Belridge Field in 1932 where the taxpayer owned important productive properties.

In 1945 Belridge acquired the lessee and royalty interests in the Continental-Result lease which was a strategically located property in the North Belridge area and productive in the 64-zone and important to control of the gas cap in this zone.

The consideration paid for the Result property by Belridge was a fixed number of barrels of oil of average field gravity, payable at a monthly rate over a period of years and at the field posted price per barrel.

Acquisition of all interests except the lessee share was accomplished and payments for this larger interest have continued in each year at increased prices much in excess of the starting price.

This purchase results in a very high unit cost base for depletion purposes since the property was acquired in contemplation of a unitization agreement and estimated oil reserves of the property itself do not appear to justify the total consideration which is being paid.

During 1950 unitization was effected and the taxpayer contributed all its properties productive in the 64-zone in exchange for a 71.87% interest in the unitized area or pool production.

In all prior years the taxpayer has consistently treated its fee holdings as a single property for depletion purposes regardless of the fact that two large oil fields were included and production was obtained from various stratagraphic depths from horizons which were of different geological age and character.

Following unitization the taxpayer has continued to claim high cost depletion on the Result property as a separate depletable interest, outside of the unit.

Prior to 1950 the Result lease was correctly depleted as a separate property and the unitization of the mineral interests is recognized as a nontaxable exchange whether effected by cross-assignments or agreement.

It is the opinion of this officer that the pooling agreement ended in a merger of all the taxpayers 64-zone wells into a single unit for depletion purposes, regardless of the number of properties contributed, since regardless of the legal form the taxpayer in substance exchanged its fee lands and the Result property for a 71.87% undivided interest or share of the unitized block.

In the event of an alternate solution of this issue which would recognize the separate properties contributed by Belridge to the unitization, it would appear necessary to allocate the adjusted basis remaining in the Result over the properties acquired upon a value basis. This procedure would dilute the cost depletion unit over the oil reserves established for parts of several sections of developed lands and the wells thereon. E. C. Laster, 43-BTA-159 (1940).

No attempt has been made to establish values for allocation purposes since the fee properties contributed by Belridge were all over depleted and their value was so far in excess of the value of the Result lands that it is obvious that no tax-wise effect would be had.

Attention is also directed to the fact that no attempt has been made to transmute any part of the adjusted basis of tangibles into the depletable basis by allocations upon a value basis.

Depletion claimed upon the high cost basis of the Result property has been denied following the unitization.

Capital Gains & Depreciation

Due to the advanced stage of the taxpayers development program as compared to other operators joining into the unitization, Belridge received $41,834.53 boot money or cash in equalization of the total value of all tangibles involved in the exchange.

This amount has been treated as capital gain since it is less than the indicated profit computed as the difference between the taxpayers adjusted basis and the total value received in the exchange.

The taxpayer treated the boot money received as a reduction of its adjusted basis in tangible assets by the process of negative depreciation provisions deducted from total provision for the year 1950 and following years and until the amount of the boot money had been offset by an equal reduction of the total adjusted basis.

The negative depreciation has been restored to the provision allowable for the year 1950 in the amount of $3,834.83.

Depletion, depreciation and capital gain adjustments are shown in detail by exhibits which accompany the R.A.R.

Unadjusted Items

All other engineering features involved in the return were verified and found to be reasonable and acceptable and accordingly no further adjustments are recommended to the deductions claimed.

R. F. WHITE, E.R.A.

Received: L.W.P 2/12/54.

Approved:

/s/ P. WILLIAMS,
Chief Natural Resources
Section.

TREASURY DEPARTMENT
Internal Revenue Bureau
Revised Oct. 1939

ENGINEERING AND VALUATION DIVISION—NATURAL RESOURCES SECTION

TAXPAYER Belridge Oil Company
(Name) (Address)

Property Bennett No Belridge
(Name) (Field)

Description S½-SW¼ Sec 36-27-20

Acres _____ Interest owned Fee

Other interests owned by —

Valuation notes —

SCHEDULE OF DEPLETION AND DEPRECIATION

Remarks:

Basic date _____

Cost of property _____

Equipment _____

Depletable sum _____

Salvage value _____

Depreciable sum _____

Exhibit "I" - Schedule 1.

Belridge Oil Company

YEAR	CAPITAL SUM—DEPLETABLE				RESERVES		PRODUCTION	UNIT COST	DEPLETION SUSTAINED	DEPLETION ALLOWABLE
	BEGINNING OF YEAR	ADDITIONS	DISPOSITIONS	TOTAL FOR YEAR	ADDED DURING YEAR	TOTAL FOR YEAR				
1950	1007976.81			1007976.81		201 106	3 330	$.012167	16690.52	16690.52
		month of January 1950 only								

YEAR	CAPITAL SUM—DEPRECIABLE				DEPRECIATION			
19								

Date RI 1-17-52 Engineer 1-31-52 Schedule No. 1

U. S. GOVERNMENT PRINTING OFFICE 16—10566

34

Received and filed August 18, 1954, T.C.U.S.

Served August 18, 1954.

[Title of Tax Court and Cause.]

ANSWER

The Commissioner of Internal Revenue, by his attorney, Daniel A. Taylor, Chief Counsel, Internal Revenue Service, for answer to the petition of the above-named taxpayer, admits and denies as follows:

I, II and III.

Admits the allegations contained in paragraphs I, II and III of the petition.

IV.

(a) to (d), inclusive. Denies the allegations of error contained in subparagraphs (a) to (d), inclusive, of paragraph IV of the petition.

V.

(a) to (f), inclusive. Admits the allegations contained in subparagraphs (a) to (f), inclusive, of paragraph V of the petition.

(g) Admits the allegations contained in subparagraph (g) of paragraph V of the petition, excepting that respondent denies that oil can be moved up or down structure from the petitioner's land by lessening or increasing the gas cap pressure, as the case may be.

(h) to (n), inclusive. Admits the allegations contained in subparagraphs (h) to (n), inclusive, of paragraph V of the petition.

(o) and (p) Denies the allegations contained in subparagraphs (o) and (p) of paragraph V of the petition.

(q) to (t), inclusive. Admits the allegations contained in subparagraphs (q) to (t), inclusive, of paragraph V of the petition.

(u) Denies the allegations contained in subparagraph (u) of paragraph V of the petition.

(v) to (z), inclusive. Admits the allegations contained in subparagraphs (v) to (z), inclusive, of paragraph V of the petition.

(aa). Admits the allegations contained in subparagraph (aa) of paragraph V of the petition, excepting that respondent denies that petitioner had claimed on its return $280,237.50 for depletion as alleged.

(bb) to (ff), inclusive. Denies the allegations contained in subparagraphs (bb) to (ff), inclusive, of paragraph V of the petition.

(gg) and (hh). Admits the allegations contained in subparagraphs (gg) and (hh) of paragraph V of the petition.

(ii) Denies the allegations contained in the first sentence of subparagraph (ii) of paragraph V of the petition; for lack of sufficient information presently available, denies the remaining allegations contained in said subparagraph.

(jj) Admits that said agreement was executed within three years from the time the tax return was filed by the petitioner; for lack of sufficient information presently available, respondent denies the remaining allegations contained in subparagraph (jj) of paragraph V of the petition.

(kk) Denies the allegations contained in subparagraph (kk) of paragraph V of the petition.

VI.

Denies each and every allegation contained in the petition not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that the determination of the Commissioner be approved.

/s/ DANIEL A. TAYLOR, R.E.M.,
Chief Counsel,
Internal Revenue Service.

Of Counsel:

MELVIN L. SEARS,
Regional Counsel;
E. C. CROUTER,
Assistant Regional Counsel;
R. E. MAIDEN, JR.,
Special Asst. to the
Regional Counsel;
RICHARD W. JANES,
Special Attorney,
Internal Revenue Service.

Filed October 5, 1954. T.C.U.S.

[Title of Tax Court and Cause.]

STIPULATION OF FACTS

It Is Hereby Stipulated and Agreed by the parties to this proceeding, through their respective counsel of record, that the facts stated and incorporated in this stipulation are true and may be found as facts by the Court, subject to the rights of either party to introduce any other and further evidence which is not contrary to the facts herein stipulated.

1. The petitioner is a corporation, duly organized and existing under the laws of the State of California, with its principal office at 1300 West Fourth Street, Los Angeles, California; and it filed its tax return for the calendar year 1950, the taxable year at issue, with the Director of Internal Revenue for the Los Angeles, California, District.

2. The statutory notice of determination of deficiency against petitioner for the year at issue was mailed to petitioner on May 28, 1954.

3. Accompanying this stipulation, marked Exhibit 1-A, and made a part hereof, is a copy of the tax return filed by the petitioner for the calendar year 1950, the year at issue.

4. Accompanying this stipulation, marked Exhibit 2-B, and made a part hereof, is a copy of the report of Examining Officer Walfred E. Runston, dated March 12, 1954, which is the "report of examination dated March 12, 1954" referred to in the

"Statement" which accompanied the statutory notice of determination dated May 28, 1954.

The parties agree to the introduction of Exhibit 2-B solely for the purpose of showing the basis used by the respondent in determining the deficiency here at issue.

5. Accompanying this stipulation, and made a part hereof, are the following exhibits:

Exhibit 3-C

A copy of the document entitled "Unit Agreement for the 64 Zone of the North Belridge Oil and Gas Field, Kern County, California," together with the six exhibits (A to F, inclusive) referred to in the Agreement and reproduced as part of Exhibit 3-C. The original of Exhibit 3-C was executed by the parties, and on the dates, shown on pages 33 and 34, and the two unnumbered pages which follow page 34, of said exhibit.

Exhibit 4-D

A copy of the document entitled, "Supplemental Agreement to Unit Agreement for the 64 Zone of the North Belridge Oil and Gas Field, Kern County, California." The original of this exhibit was executed by the parties listed on pages 12 and 13 of the exhibit.

Exhibit 5-E

A copy of the document entitled "Agreement," dated January 17, 1950, the original of

which was executed by the parties listed on pages 1 and 2 of the exhibit.

6. The original of the document which is reproduced on page 45 of Exhibit 3-C (that is Exhibit F of said exhibit) was executed by R. D. Bush, Oil and Gas Supervisor of the State of California, on October 27, 1949.

7. A number of the originals of the document entitled, "Lessors' and Royalty Owners' Consent" (which is reproduced as Exhibit E on pages 41-44 of Exhibit 3-C) were executed by lessors and royalty owners who possessed interests in the 64 Zone covered by the leases held by The Texas Company and Union Oil Company of California; and each of the two named companies endorsed its acceptance on the documents executed by those with interests in the 64 Zone covered by its lease.

No "Lessors' and Royalty Owners' Consent" was executed or endorsed by the owners of fee properties, that is, petitioner, Tide Water Associated Oil Company, Richfield Oil Corporation, and Standard Oil Company of California.

8. At various places in Exhibit 3-C reference is made to a "Belridge Lease" held by Union Oil Company of California. The quoted words are descriptive only, and petitioner did not execute, or participate in the execution of the "Belridge Lease" to Union Oil Company.

9. On page 35 of Exhibit 3-C (Exhibit A of Exhibit 3-C), the various dots and stars, next to each of

which is printed a small numeral, represent wells drilled to the 64 Zone.

Tide Water Associated's wells 1 and 35 in Section 21, and petitioner's well 8 in Section 27 were "dual wells," drilled and operating in both the 64 Zone and the R Zone. There was and is a physical separation of the production from the two zones, and production from the R Zone was obtained through the space between the wall of the well casing and the wall of a tube inside the casing, and production from the 64 Zone was obtained from said inner tubing.

After Exhibit 3-C went into effect, the "Operator" under said agreement made a monthly service charge to Tide Water Associated and Belridge covering operations of the dual wells in the R Zone.

10. Accompanying this stipulation, marked Exhibit 6-F, and made a part hereof, is a contour map of the 64 Zone. However, the various dots and symbols, next to each of which is printed a small numeral, represent wells drilled to all five producing zones in the area, and are not restricted to wells drilled to the 64 Zone. The exhibit on page 35 of Exhibit 3-C identifies the wells drilled to the 64 Zone.

11. After Exhibit 3-C went into effect, petitioner continued to operate and produce from the Shallow, Temblor, R, and Y Zones underlying the same surface area of its Main Property as that covered by Exhibit 3-C. Likewise Richfield Oil Corporation, Tide Water Associated Oil Company, The Texas

Company, and Union Oil Company of California continued to operate and produce from one or more of said four zones underlying the same surface area of their respective properties as were covered by Exhibit 3-C.

In 1954, petitioner resumed production from the Temblor Zone of its Result Property. No production was taken from the Temblor Zone of the Result Property in the years 1949 to 1953, inclusive.

12. At February 1, 1950, the perimeter of the gas cap of the 64 Zone was approximately within the 7,500-foot contour shown on Exhibit 6-F.

13. On Exhibit 6-F, the surface boundaries of the petitioner's Result Property are shown by the rectangle, the four corners of which are marked by red pencil.

14. After Exhibit 3-C went into effect, the Operator under the agreement injected gas into the 64 Zone through several of the existing wells which extended into the Zone. None of the gas injection wells are located on the Result Property.

15. No Federal income tax return, partnership return, or fiduciary return was filed by or for the unit operation conducted under the provisions of Exhibit 3-C for the year 1950, or for any subsequent year up to the date of this stipulation. And as of the date of this stipulation, the petitioner (in its own right and as the operator under Exhibit 3-C) has not received any demand or request that any such return be filed by or for the unit operation.

16. For the purposes of this proceeding, it is agreed that cost depletion, if any, allowable to petitioner, has been and is to be computed on the basis of oil production only, as distinguished from production of gas, gasoline, butane, and liquid petroleum gas products.

16. Prior to the effective date of Exhibit 3-C, both the commissioner and the petitioner computed cost depletion respecting Result upon the basis of oil reserves and oil production only, exclusive of other hydrocarbon products such as gas, butane, etc. Only with respect to the tax year involved in this proceeding, it is agreed by the parties that if cost depletion is determined to be allowable to Result as a separate property, such depletion may be similarly computed on the basis of oil reserves and oil production only, exclusive of other products.

16a. Should the petitioner be successful in maintaining that cost depletion is allowable to Result as a separate property, it is further expressly agreed that each party may be free to maintain that for subsequent years a different basis may be used in computing cost depletion for Result.

17. For the purposes of this proceeding, it is agreed that prior to the year 1950, the petitioner had completely recovered, through depletion allowances, its tax basis for its Main Property, as distinguished from its Result Property.

18. Petitioner acquired the working interest and the landowner and royalty owners' rights in the

Result property as of September 1, 1944. Accompanying this stipulation, marked Exhibit 7-G and made a part hereof, is a copy of the agreement pursuant to which petitioner acquired the working interest. The various landowner and royalty interests were acquired concurrently, calling for cash payments of a similar nature, measured by the cash value of stated numbers of barrels of oil, valued as of the due dates of the installment payments.

Although the Result property contained and contains reserves of wet gas as well as oil reserves, the measure of the total consideration which petitioner obligated itself to pay for the property was the cash value of 820,107 barrels of oil.

Subsequent to the year at issue, and prior to the date of this stipulation, petitioner has completed payment for the Result property at a cost (for mineral rights, equipment, and land) as follows:

Payments to Continental Oil Company	$1,727,284.20
Payments for landowner and royalty interests	184,443.97
Other costs	1,225.64
Total	$1,912,953.81

19. The oil reserves of the Result property as of September 1, 1944 (as agreed to by the petitioner and the respondent), and the oil production from the property through January 31, 1950, are as follows:

	Barrels of Oil		
	64 Zone	Temblor Zone	Total
Reserve at 9/1/44	350,349	39,247	389,596
Deduct: Production			
9/1/44 to 12/31/44	19,349	5,247	24,596
Year: 1945	23,645	1,869	25,514
1946	33,324	–0–	33,324
1947	39,998	1,628	41,626
1948	25,908	6,705	32,613
1949	30,817	–0–	30,817
	173,041	15,449	188,490
Remaining Reserve, 1/1/50	177,308	23,798	201,106
Deduct: January, 1950 Prod.	3,330	–0–	3,330
Remaining Reserve, 1/31/50	173,978	23,798	197,776

20. Prior to the effective date of Exhibit 3-C, the petitioner and the respondent have consistently followed the procedure of lumping oil production from both the 64 and Temblor Zones of the Result property in computing cost depletion on the Result property.

21. The basis for depletion of the Result property, as provided in Section 114(b) of the Internal Revenue Code of 1939, was $1,007,976.81 at January 1, 1950. Subsequent to January 31, 1950, and prior to December 31, 1950, the cost to the petitioner of the Result property was increased in the amount of $8,886.29, by reason of increases in the posted field price for oil which increased the cash outlay which petitioner was obligated to make for the purchase of the Result property.

On its 1950 tax return (Exhibit 1-A), petitioner had erroneously reported $689,863.29 as the basis for depletion of the Result property.

22. During the period of unit operations under Exhibit 3-C (that is, from February 1, to December 31, 1950, inclusive), a total of 428,139 barrels of oil were produced from the 64 Zone as follows:

(a) 21,672 barrels from wells located on the surface area of the Result property.

(b) 215,390 barrels from wells located on the surface area of the petitioner's Main Property.

(c) 191,077 barrels from wells located on the surface area of the other participants who were parties to Exhibit 3-C.

23. Of the total oil production from the 64 Zone for the period February 1, to December 31, 1950 (428,139 barrels), 71.87%, or 307,704 barrels, was allotted to petitioner under Exhibit 3-C, and 28.13%, or 120,435 barrels, was allotted to the other participants under Exhibit 3-C.

24. The production of oil from the Result property for the period April 1, 1947, to January 31, 1950, was as follows:

	Barrels of Oil		
	64 Zone	Temblor Zone	Total
4/1/47 to 12/31/47	30,206	1,628	31,834
Year: 1948	25,908	6,705	32,613
1949	30,817	–0–	30,817
January, 1950	3,330	–0–	3,330
Total	90,261	8,333	98,594

The total Result oil production from the 64 Zone for this period (90,261 barrels) was:

(a) 4.29% of the petitioner's total oil production from the same Zone for the same period (2,102,158 barrels); and

(b) 2.77% of the total oil production from the same Zone for the same period (3,255,417 barrels).

25. The production of oil from the petitioner's Main Property for the period April 1, 1947, to January 31, 1950, was as follows:

	Barrels of Oil		
	64 Zone	All Other Zones	Total
4/1/47 to 12/31/47	773,704	460,375	1,234,079
Year: 1948	693,361	940,791	1,634,152
1949	506,421	994,946	1,501,367
January, 1950	38,411	88,268	126,679
Total	2,011,897	2,484,380	4,496,277

26. During the period February 1, 1950, to December 31, 1950, the actual oil production from wells on the surface areas of the petitioner's Result property and its Main Property was as follows:

Result Property:

	Barrels of Oil		
	64 Zone	Tremblor Zone	Total
2/1 to 12/31/50	21,672	–0–	21,672

Main Property:

	Barrels of Oil		
	64 Zone	All Other Zones	Total
2/1 to 12/31/50	215,390	1,170,355	1,385,745

27. During the year 1949, oil production from the 64 Zone of the Result property (30,817 barrels) was:

(a) 5.74% of the petitioner's total oil production for 1949 from the 64 Zone (537,238 barrels); and

(b) 3.55% of the total oil production from the 64 Zone for 1949 (867,915 barrels).

28. During the month of January, 1950, oil production from the 64 Zone of the Result property (3,330 barrels) was:

(a) 7.98% of the petitioner's total oil production for the same month from the 64 Zone (41,741 barrels); and

(b) 5.20% of the total oil production from the 64 Zone for the same month (64,010 barrels).

29. On its return for the calendar year 1950, the petitioner allotted 17,662 barrels of unit oil production from the 64 Zone, for the period February 1 to December 31, 1950, to the Result property, on the basis of the relationship which actual Result 64 Zone oil production for the competitive year 1949, bore to the petitioner's total oil production from the 64 Zone for the same year.

The allotted production was computed as follows:

1949 Result 64 Zone oil production as a percentage of petitioner's 1949 total 64 Zone oil production	5.74%
64 Zone oil production allotted to petitioner under Exhibit 3-C, for the period February 1 to December 31, 1950 (71.87% of 428,139 barrels, the actual unit production)	307,704 barrels
5.74% of 307,704 equals unit production allotted to Result property, or	17,662 barrels (in round figures)

Or, expressing the same data as a percentage of total unit production, the computation would be as follows:

5.74% times 71.87% equals 4.125338%.

4.125338% of 428,139 equals 17,662 barrels, in round figures.

30. On its return for the calendar year 1950, the petitioner computed the cost depletion claimed by it, with respect to the Result property, as follows:

(a)	Depletable basis claimed on return		$689,863.29
(b)	Oil reserve (barrels)		201,106
(c)	Unit cost ((a) ÷ (b))		$ 3.43035
(d)	Production (barrels):		
	January, 1950	3,330	
	Allotted unit production (See Paragraph 29 of Stipulation)	17,662.21	20,992.21
(e)	Cost depletion ((c) times (d))		$ 72,010.63

31. In his determination of the deficiency at issue, the respondent computed the cost depletion allowable on the Result property as follows:

(a)	Depletable basis	$1,007,976.81
(b)	Oil reserve (barrels)	201,106
(c)	Unit cost ((a) ÷ (b))	5.0121667
(d)	Production (barrels):	
	January, 1950	3,330
(e)	Cost depletion ((c) times (d))	$ 16,690.52

32. For the purposes of this proceeding, it is agreed that at January 1, 1950, the oil reserves, in terms of the number of units of oil remaining as of

the taxable year, were 3,100,000 barrels for the entire 64 Zone and 1,890,000 barrels for the 64 Zone of the petitioner's Main Property. During the month of January, 1950, 64,011 barrels of oil were produced from the 64 Zone.

33. The petitioner, aside from the claim of overpayment made in its petition, has not filed a refund claim for the year at issue; and no part of the income and excess profits taxes of $1,019,485.40, paid by it for the year at issue, has been refunded or otherwise credited to the petitioner.

34. Petitioner paid a $203,897.08 installment of its 1950 taxes on December 7, 1951, which amount was paid within two years before the November 2, 1953, execution by the petitioner and the respondent of the extension agreement pursuant to Section 276(b) of the 1939 Code; and said agreement was executed within three years from May 5, 1951, the date the petitioner filed its tax return for the year.

35. The estimated wet gas reserves of the Result property as of September 1, 1944, and the production of wet gas from the property through January 31, 1950 (both expressed in units of one thousand cubic feet of wet gas, the symbol for which is m.c.f.) are as follows:

	M.c.f. of Wet Gas		
	64 Zone	Tremlor Zone	Total
Estimated Reserve, 9/1/44			5,944,610
Deduct: Production			
9/1/44 to 12/31/44	789,315	18,295	807,610
Year: 1945	553,592	6,431	560,023
1946	703,213	–0–	703,213

1947	1,738,318	1,577	1,739,895
1948	958,895	34,374	993,269
1949	1,141,392	–0–	1,141,392
	5,884,725	60,677	5,945,402
At 1/1/50, excess of production over estimated reserves			792
Add: January, 1950 Prod.	80,173	–0–	80,173
At 1/3/50, excess of production over estimated reserves			80,965

36. During the period of unit operations under Exhibit 3-C (that is, from February 1 to December 31, 1950, inclusive) a total of 273,813 m.c.f. of wet gas was produced from wells located on the surface area of the Result property, all of which came from the 64 Zone.

37. Any reference in this stipulation to production from the Result property shall mean production from wells located on the surface area of the Result property.

February 1, 1956.

Respectfully submitted,

/s/ HARRISON HARKINS,
Counsel for Petitioner.

/s/ JOHN POTTS BARNES, R.E.M.
Chief Counsel, Internal Revenue Service, Counsel for Respondent.

Filed at hearing February 1, 1956.

The Tax Court of the United States

Docket No. 54288

BELRIDGE OIL COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

(Met pursuant to notice.)

Before: Honorable Stephen E. Rice, Judge.

Appearances:

HARRISON HARKINS and
JOHN B. MILLIKEN,
Appearing for and on Behalf of Petitioner.

RICHARD W. JANES,
Appearing for and on Behalf of the Respondent.

Proceedings

The Clerk: Docket No. 54288, Belridge Oil Company.

OPENING STATEMENT ON BEHALF OF THE PETITIONER

By Mr. Harkins:

Your Honor, this appeal involves income and excess profits tax deficiency for the calendar year 1950 in the amount of $43,746.32. The deficiency re-

sults from a disallowance of cost depletion claimed and a limitation on percentage depletion claimed on the petitioner's 1950 return.

The basis for these adjustments is such that if the respondent prevails here on his theory, it will have a continuing effect in subsequent years.

Now, the background of the matter is that the petitioner is the producer of oil and gas, and in 1911, it became the owner of what has been described in the petition as its main property, an acreage of some thirty thousand eight hundred odd acres. In the course of the development of the Main Property, they have produced from some five or more separate zones of oil and gas, and although oil and gas was produced from these various zones, both the petitioner and the respondent in prior years have consistently treated this as one property for depletion purposes, and we are agreed for the purpose of this proceeding that there has been a complete recovery of costs on the Main Property in prior years, and on the return, percentage depletion was claimed [3*] with respect to this Main Property.

In 1944 or 1945, the petitioner purchased the property which is described in the petition as the Result Property, somewhat adjacent to its main property, an 80-acre tract, and oil and gas has been produced from two separate zones underlying the Result Property, but in past years, both the Commissioner and the petitioner have consistently treated

*Page numbering appearing at top of page of original Reporter's Transcript of Record.

the Result Property as a separate property to be depleted as a unit. The depletion for all years since acquisition has been on the basis of cost depletion because that was higher than the percentage depletion, and in the year at issue, cost depletion was claimed on the Result Property.

Now, the so-called 64 Zone, or an oil and gas structure, underlies the petitioner's Main Property and also its Result Property and also the properties owned or operated by five other oil companies in the North Belridge Field. Competitive production from the 64 Zone had proved to be wasteful, and as of February 1st, 1950, the six companies agreed to develop the 64 Zone as a unit under the agency of a designated operator, and the petitioner was designated as the operator and has continued to act as such.

Now, the agreements which the six parties entered into are identified in the stipulation, which is to be filed as Exhibits 3-C, 4-D and 5-E. The main issue in this case involves the proper interpretation of this unit agreement [4] document in the interpretation of the document itself or the effects of the document. The petitioner claims that the agreement simply provides for the co-operative development and operation of the 64 Zone as a unit, and was not a title passing agreement. The respondent claims that either the unit agreement or the substance or the results of the unit agreement is that an exchange of property interest occurred, and that the petitioner made a non-taxable exchange of its 64 Zone property interest for an undivided interest in the unit operation of the 64 Zone, and that by reason of that exchange, the new interest

acquired took a basis—took the adjusted basis of the properties transferred, and it must be treated in the future as a separate property, so we have the situation that prior to the execution of this unit agreement, the petitioner had two depletable properties, its Result Property and its Main Property.

Under the respondent's theory, and the theory on which this deficiency has been proposed, it now has three properties, namely, its interest in the unit operation of the 64 Zone, its Main Property exclusive of the 64 Zone, and its Result Property exclusive of the 64 Zone.

The practical effects of this theory are that the cost depletion claimed on the Result Property from February 1st to December 31st of 1955 has been disallowed. Percentage depletion computed by the Commissioner on this new property [5] which he asserts arose out of the unit has become subject to the 50 per cent limitation—50 per cent of net income limitation, and a portion of the percentage depletion claimed on the return has been disallowed.

The Main Property, the percentage depletion has been computed on that by the Commissioner, and that is not subject to a 50 per cent of net income limitation.

Now, the theory of the Commissioner—the disallowance of cost depletion on the Result Property and the treating the 64 Zone as a separate depletable interest—will result in added deficiencies in other years if the Commissioner's theory is upheld.

Now, if the Court should decide that the unit agreement resulted in an exchange of property in-

terest as the respondent claims, then the deficiency asserted is in order with a matter of adjustment of some one hundred twenty or one hundred thirty dollars. If the Court should decide that the respondent is wrong on this main issue and that there was no exchange of property interest, then there would still remain for a decision a further issue raised by the respondent as to the proper method of computing cost depletion on the Result Property. He disputes the method claimed in the return.

We believe that the facts covered by the stipulation to be submitted will, along with the argument and the brief, enable the Court to dispose of this latter issue if it should arise in the course of the case. We have a stipulation with some seven exhibits that will later be submitted.

The petitioner believes that that covers the case as far as it is concerned and they will not introduce evidence.

OPENING STATEMENT ON BEHALF OF THE RESPONDENT

By Mr. Janes:

At first, respondent would like to put in the record that there was an inadvertent denial to the Answer respecting V (g) of the petition. In the Answer with respect to V (g), respondent had admitted a portion and denied a portion of that paragraph. Respondent would now admit the entire paragraph (g); the portion that had been denied, your Honor, was the last half of the second sentence be-

ginning with, "excepting that respondent denies that oil can be moved up or down structure on petitioner's land."

We now admit that such can be done.

The Court: In other words, you want to knock out the "except" clause in your paragraph V (g)?

Mr. Janes: That is right, sir.

The respondent's position in this case is that as a result of the unitization agreement, a new economic interest was obtained by petitioner. The facts in this case, as respondent sees them, are not materially different from what petitioner stated. I think that possibly an analogy or two might help us to understand the problem here. [7]

The unit agreement took place between five separate tax entities, five separate corporations. Petitioner contributed to that unit agreement, in effect, two separate depletable properties. The first was the large bulk of his properties, the Main Property and the Result Property. The Result Property was about 180 acres, I think, so it is considerably smaller in geographical extent than the Main Property contributed.

The other five participants were property interest owners in this oil field. The reason competitive oil interests get together generally to unitize a field is to promote the economic development of the entire field to the mutual benefit of all participants. Such was done in this case. The underlying petitioners contributed properties, the Main, on the one hand, the Result on the other. About 8,000 feet is the zone known as the 64 Zone or Wagon Wheel Zone. The unit agreement only pertained to that zone.

It is as if a checkerboard—as if a layer cake had a checkerboard laid out on top in six squares, and one owner for this analogy, let us say, owned two of the squares and other owners owned the other four they contributed. Well, what they are talking about in the agreement is not the surface or even the first strata. In this instance, it is the middle layer of the cake, and that is all that was involved in this unit. [8]

Under the law, as respondent views it, such an arrangement generally, and in this particular instance, results in a new depletable property, a merger of all the participants into the new.

Let's take this particular case. The taxpayer owns one checker square and the rights to the middle layer of the cake. We will call that the Main Property. He also owns the second checker square with the rights to the oil production from the middle layer of the cake, the 64 Zone.

At that time, prior to the agreement, the taxpayer owns 100 per cent of what rights in oil under the law of oil ownership he can have to the middle layer. This case will involve the exact definition of oil ownership, of course, but prior to the agreement, he owns 100 per cent of the interest in the oil in the middle layer of the cake. After the agreement he owns no such thing. He doesn't own a single percentage of any oil under either one of the two squares contributed. He owns 71.87 per cent of the oil produced by the oil operator of the entire field. He has given up his 100 per cent right to take and keep oil from wells drilled on the surface of this

property in exchange for 71.87 per cent of what the operator of the entire field produces.

Theoretically, in these kind of agreements, the operator would have the right to go to any one of the participants and tell him, "You can't drill your wells for the [9] good of the field. We don't want you to bleed off the gas. We want to maintain constant pressure down through these zones."

Now, those are the facts as we see them prior to the agreement.

Now, the terms of the agreement, respondent feels, show that the participants and the taxpayer in effect obtained a new economic interest, a new depletable property, a new property, with "property" in quotation marks as that word is used in the field of oil and gas.

Let us turn briefly to the agreement which will be Exhibit—which will be an exhibit in this case, and without, of course, reading the entire agreement, I will point to two or three or four sections therein which show that the respondent is taking the only result, in its opinion, under the agreement. Then we will look briefly at the law involved in order to help the Court at this time understand the purpose of certain factual evidence respondent will wish to get into the record.

Now, with respect to the rights of the parties, on Page 4 of the agreement—you want to remember that this agreement—that that unitization agreement is what we are taking about, and this is a contract, an agreement, an agency, or whatever we wish to

call it, a joint venture. It is a mutual contractual device to contractually guarantee to the participants the rights involved. [10]

Now, on Page 4, with respect to the rights of the various parties, Section 1:

"The rights of participants to develop and operate in and to produce from the 64 Zone oil, gas and associated hydrocarbons, and the oil, gas and associated hydrocarbons in the 64 Zone," that is the middle layer of our cake—"and produce therefrom, are hereby unitized to the end that the 64 Zone shall be developed and operated as a unit by a single operator for the benefit of participants."

Further down, Section 2:

"Operations hereunder shall be conducted in accordance with sound and efficient oil field practices for the purpose of properly conserving the natural resources of the 64 Zone and endeavoring to obtain ultimately the maximum economic recovery of Unitized Substances."

That is the oil available from the 64 Zone.

"The powers of the operator"—well, Page 13:

"The initial participants collectively are the owners on the date of this agreement of the right to develop and operate all lands within the area and to produce Unitized Substances"—oil.

Now, that is all they owned. We don't own any oil in the ground. That is what they owned at that time. [11]

(Continuing): "And are the initial signatory parties. At the effective time of this agreement, Operator shall take exclusive possession of the op-

erating rights of each participant in and to the 64 Zone and enter into the performance of its duties hereunder; subject, however, to the right of each participant to use and occupy its lands within the area pursuant to Section 3, Article II."

Well, now, "subject to" means other than the 64 Zone. That is, the participants who owned the surface rights or the rights in other layers of the cake could go down and develop those.

"Ownership of Unitized Substances." Well, who owns them?

"Each participant shall own a percentage of Unitized Substances equal to the participating equity of such participant."

Prior to the agreement, under the oil and gas law, the participants do not own any oil and gas at all. All they own is the right to take it, that is all they could transfer. What do they get back from the operator? "Equal to the participating equity of such participant." The taxpayer gets back 71.87 per cent of the whole field. It would matter none whether they produced—whether the operator, or acting under the contract, the agents of the operator produced one cubic [12] foot of gas or one quart of oil. It makes no difference, or if they told them not to produce at all from taxpayer's own wells. The production from all wells is allocated to the participants.

"The participants shall own, as tenants in common, all unit wells and unit facilities, and each participant shall own an undivided interest in the unit

wells and unit facilities equal to the participating equity of such participant."

Now, after the operator operating under this agreement—how is what is produced disposed of? Article VIII, Sections 1 and 2:

"Each participant shall accept its share of the Unitized Substances currently in kind as provided,

"Each participant shall take in kind its participating equity share of the crude oil."

That is all he can get, just a percentage of what is produced.

Now, there are restrictions in this agreement with respect to the middle layer of the cake here.

"Any participant shall have the right, at any time, without consulting any other participant, to surrender and quitclaim any interest held by it in and to lands within the area other than the [13] right to drill for, develop and produce Unitized Substances."

Now, the taxes clause in here is interesting. Section 2, for the tax year 1950—well, it amounts to this: That each participant who has paid less State taxes than the amount apportioned to it shall pay the difference to the operator.

In other words, if one of the individuals gets a better State tax levy than the other, you still pool your group liability for State taxes, and then apportion it back plus or minus, much as settling up a gin rummy game among three people.

Now, let's see about transfers. This is from XI, Section 1:

"Each participant shall retain the right at any

time or from time to time to sell, assign, transfer," and so forth, "dispose of, subject to this agreement, its interests."

That ties them up there.

Now, the duration. This is XII, Section 2:

"This agreement, upon becoming effective as provided," and so forth, "shall continue in full force and effect as long as Unitized Substances, or any of them, can be produced from the 64 Zone in quantities determined by participants to be [14] sufficient to pay to produce."

In other words, as long as it is economically advisable.

"However, that this agreement may be terminated prior to such expiration date by the unanimous consent of all participants."

There are other sections in here, which, of course, will go in on brief, your Honor.

There is one interesting point I would like to bring out respecting this instrument as it particularly affects this taxpayer. It will be remembered that there were six separate oil corporations involved in this agreement. Belridge, in effect, contributed what, prior to the agreement, were properly depletable separate properties. One of the other five contributed two or three separate properties. On Page 36 of the agreement—excuse me—on Page 36 of this exhibit, which includes the agreement and is Exhibit B, it sets out Belridge Oil Company's participating equity, that is, the tract value. Belridge, as we know, under the taxpayer's theory, contributed two separate depletable properties to

this agreement, and the taxpayer still alleges that it still has two separate depletable units remaining all during the tenure of this agreement, yet when Belridge contributed his two separate properties, Belridge was allocated 71.87 per cent of what it contributed. There was no allocation [15] in the agreement between Property One and Property Two of Belridge. Belridge was given 71.87 of what it contributed, one plus two equals 87 per cent, as far as Belridge is concerned. No allocation here.

In effect, it might be stated that Belridge voluntarily merged these two properties prior to the agreement or at some time immediately prior.

In Exhibit B, Pages 37, 38 of the attachments it shows that Union Oil was awarded no interest for one lease; 1.18 per cent for a separate lease; and 0.01 per cent for a third lease. In other words, Union separated its properties for allocation purposes in the agreement, but it may be stated that, nevertheless, respondent would treat Union as having received back one depletable unit.

The idea of a merger or exchange, of course, under the respondent's viewpoint—what took place was a like for like exchange, our old friend 112-B-1, not taxable, and I may briefly touch on the facts behind the agreement involved here.

I think we should realize that under respondent's view, the issues here should be divided within the framework of the oil and gas property rights, and that to ultimately decide, in respondent's view, from analogies too strongly drawn from three dimensional law concepts, I think leads us into an eco-

nomic error for the reason that depletion, like depreciation, follows income. [16]

Now, the income received by taxpayer in this year with respect to the unit agreement came from all properties. The taxpayer received only 71.87 per cent of what the operator produced from the field. The taxpayer cannot show what portion of the oil allocated to it came from the Result Property or from its Main Property. It was allocated 71.87 per cent from the entire field. In effect, taxpayer, by carving out Result as a separate depletable property, and making an arbitrary or an estimate allocation to it for cost depletion purposes, ignores the fact basically that it was receiving income from wells drilled on the surface of strangers, other participants in the unit.

I would like to state that I believe it is agreed by all hands that this is a novel question in the sense that it is presented to this court now, and to a larger sense, too, that is to say, there are no judicial opinions directly in point, and actually no I.T.'s directly on it, as such. We have to return to the practicalities, the economic purposes of the peculiar concepts of oil and gas property ownership—ownership, rather. They only own the right to take and keep oil when and if they produce it. There are one or two authorities on the subject which are directly in accord with respondent's position here. I will just touch upon them briefly.

This is Page 6, Oil and Gas Tax Quartely, Volume III, Number 1, October, 1953. [17]

Mr. Harkins: Your Honor, I believe this is

getting much beyond the province of an opening statement. I haven't interrupted to date because I just feel that the Court appreciates that this agreement will have to be interpreted and decided on its terms rather than a shotgun reading from its contents and admission of other contents, but when you begin to get into authorities, which are, after all, just editorial comments, I feel sure it is getting beyond the province of an opening statement and is something that should be covered by brief.

Mr. Janes: I am about to conclude, your Honor.

The Court: All right. Go ahead.

Mr. Janes: I would like to add, however, that I did not wish to make an unfair reading of excerpts from the agreement; that I did not wish to read the entire agreement, but those portions which we felt illustrative of the position taken by respondent. I will not go further into the law at this stage. Thank you, sir.

The Court: Does that complete the case?

Mr. Harkins: Yes, your Honor. I wish to reiterate that I am not answering counsel's statement because I feel that that is something that should be handled on brief and will be handled on brief.

The Court: Well, the whole document will be in evidence, will it not? [18]

Mr. Harkins: Yes. It will be in evidence as part of the stipulation.

The Court: I don't believe you need to feel unduly worried about counsel's opening statement.

I would like seriatim briefs in this case, gentlemen.

Mr. Harkins: Your Honor, I misled you. I believe counsel for the respondent is going to call a witness.

The Court: Make your appearances for the record. I believe you forgot to give them.

Mr. Harkins: Harrison Harkins and John B. Milliken for petitioner.

Mr. Janes: Richard W. Janes for respondent.

Mr. Harkins: I would like at this time to offer the stipulation of facts together with the seven exhibits which are referred to and are to accompany that.

The Court: Very well. It will be received.

The Clerk: That will be Joint Exhibit 1-A through 7-G.

(The documents above referred to were received in evidence and marked Joint Exhibits Nos. 1-A through 7-G.)

Mr. Janes: If we may withdraw the 30-day letter for photostating?

The Court: Permission granted. [19]

Mr. Harkins: The petitioner rests, your Honor.

Mr. Janes: If the Court please, may respondent ask the indulgence of the Court for five minutes? I think by consulting a revenue agent, we may well shorten what might be an hour down to ten minutes.

The Court: Certainly. We will have a brief recess.

(Short recess taken.)

Mr. Janes: We will call Roger White.

Whereupon,

ROGER F. WHITE

called as a witness for and on behalf of the Respondent, having been first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Janes:

Q. What is your name?

A. Roger F. White.

Q. What is your occupation?

A. I am a revenue agent, engineer revenue agent.

Q. Engineer revenue agent in what particular branch?

A. Particularly in natural resource cases, oil and gas and other natural resources.

Q. How long have you been associated with the oil and gas natural resource field?

A. Well, ever since—well, I was graduated from the [20] Colorado School of Mines. I followed the mining and the oil profession ever since I graduated from college.

Q. For quite a few years. We won't pin you down to the exact number.

And you have been employed as engineer revenue agent with the Bureau for a number of years?

A. In Los Angeles since 1939.

Q. You were in the courtroom, I take it, during the opening statements of counsel involving the unitization agreement which the taxpayer joined?

A. Yes, sir.

(Testimony of Roger F. White.)

Q. Did you have occasion prior to today to have any knowledge with respect to the particular oil field involved in this case? A. Yes.

Q. Did you have occasion in the course of your duties, and in your expert knowledge, to examine the unitization agreement and attendant exhibits?

A. Yes.

Q. I show you Joint Exhibit 6-F, Mr. White, which apparently is a geological contour map, and will you please tell us first: What is the area and to what does it pertain? What is it about, in other words?

A. Well, it is a structural contour map showing the underlying structure on the 64 Zone or 64 Sand. In other [21] words, it indicates an anticline and the faulting and other structural features pertaining to the 64 Zone in the North Belridge Field. It also shows the properties of the various leases and owners and the location of the wells.

Q. During the opening statement, Mr. White, respondent stated that the 64 Zone involved is analogous to a middle layer, let us say, of a cake. This map, I take it, then, is a contour map of the middle layer of the cake known as the 64 Zone?

A. It is a contour map on the top of the 64 Zone.

Q. Now, you say the top of the zone. The zone has a thickness, does it not? A. Yes.

Q. Now, I believe most of us are somewhat familiar with the contour map on the surface of the earth. This is comparable, is it not?

(Testimony of Roger F. White.)

A. This is comparable to that, except that its contour is on the horizon underneath the earth.

Q. Yes, but if the top of the 64 Zone were on the surface of the earth, these contour lines would show the varying degrees of altitude of hills, or——

A. No. The structural attitude of the rocks is something in the nature of an elongated dome. These contours indicate that it is an elongated dome, that is, the attitude of the horizon of the 64 Zone, whether it was on the surface [22] or 7,000 feet below the surface, it remains the same. The contour map—if this was on the surface—as quite often you do have structural exposures on the surface—you would still have this kind of a contour map regardless of the surface erosional features which would make the surface contours entirely different.

Q. Now, this map is in what field?

A. It is in the North Belridge Field.

Q. And it shows the 64 Zone. Now, what was that about a dome? In other words—strike that.

I will begin backwards. What is a gas cap in petroleum geology parlance?

A. Well, a gas cap is the accumulation of gas on the structure. Usually the gas separates out on top following the natural laws of physics. In this case, the gas is presumed to be in the top part of the structure.

Q. Do you know, with your familiarity with this field, and the general outlines from this map, which contour lines delineates the gas cap?

A. I have read in some of the material fur-

(Testimony of Roger F. White.)

nished the court that it is roughly the edge of the gas—the lower edge of the gas is roughly at the 7,500-foot contour. Now, that is a generalization, of course. You can't see 8,000 feet in the ground. I assume that is where it is.

Q. Well, on the basis of known geological [23] techniques, and your familiarity with the exhibits in this case and with this field, in particular, you would say that the outer delineation of the gas cap is a 7,500-foot contour?

A. I have no knowledge of the exact position of that gas cap. I mean no—I have never seen any evidence of it, no.

Q. From the pertinent material that you have seen, you would assume that that is where it is?

A. I would assume that is it.

Q. Would you draw a pencil line on this exhibit or make little x marks on this exhibit three or four inches apart around the 7,500-foot delineation contour?

A. Well, the 7,500-foot contour is marked here all along here.

Mr. Harkins: Your Honor, we stipulate the perimeter of the gas cap in the stipulation. It is not—I mean I have no objection to this procedure, but it is not at the 7,500-foot contour. It is within the 7,500 contour. I don't know the purpose of these markings.

Mr. Janes: Well, the word "within" is in the stipulation.

Mr. Harkins: Yes.

(Testimony of Roger F. White.)

Mr. Janes: And I was going to get Mr. White to show on the exhibit what is meant by "within." [24]

Q. (By Mr. Janes): When we say within the contour lies the gas cap, where is it?

A. Everything above the 7,500-foot zone would be—that part of the zone above the 7,500-foot contour would be occupied by gas. It would be the gas zone. In other words, everything above the 7,500-foot contour, everything from here to the top of the structure and from here to the top of the structure. (Indicating.)

Q. Now, on this exhibit, you see, Mr. White, we have a lot of circles with numbers around them and 7,500. A. Well, this is marked——

Q. When you say "within," you mean from 75 to 74 to 73 to 72 to 71, is that it?

A. That's right.

Q. So all the contour lines running downward numerically from 7,500 include the gas cap?

A. Well, that is really running upward, because these are the depths below a fixed base, either sea level or a fixed basis, so this is the highest part of the structure here. Everything from the top down to the 7,500-foot zone presumably would be the gas cap.

Mr. Janes: Counsel, on this exhibit are four red check marks around a rectangle called Belridge Result. I take it we may stipulate those marks show the surface dimensions of the Result Property? [25]

Mr. Harkins: We have that in the stipulation.

Mr. Janes: That is in there?

(Testimony of Roger F. White.)

Mr. Harkins: Yes.

Mr. Janes: Thank you.

Q. (By Mr. Janes): These rectangular lines indicate what on the map?

A. Parcels of land and the land grid, the side lines, section lines, property lines.

Q. They are sections broken up into parcels?

A. Yes.

Q. And the ownership is stated in the center of each parcel? A. Yes.

Q. You are aware that this lawsuit involves the petitioner, Belridge Oil Company?

A. That's right.

Q. Would you please mark on this exhibit by shading in the corners of the parcels owned by Belridge where they overlie the gas cap on this exhibit?

Mr. Harkins: Your Honor, our stipulation reads that as of February 1st, 1950, the perimeter of the gas cap was within the 7,500-foot contour. If counsel wants the exhibit to be marked, and if Mr. White is going to proceed on the basis of within the 7,500-foot contour, then I would like the record to show that that is the situation as of [26] February 1st, 1950.

Mr. Janes: Yes. I just wish to have the rectangles marked out overlying the contour lines, counsel.

The Court: All right. Go ahead.

The Witness: Would you read that question again?

Q. (By Mr. Janes): Would you please mark

(Testimony of Roger F. White.)

out on this map where parcels of land owned by Belridge as of the date of the unitization agreement——

The Court: Is that February 1?

Mr. Janes: February 1, yes, sir, 1950.

Q. (By Mr. Janes): ——overlie the geological contour markings? Now, we already have Belridge marked out. We could shade that in.

A. This is a big job.

(Witness does as requested.)

The Court: Now, what do those markings mean that you have just put on the map?

The Witness: Well, that designates the 7,500-foot contour on the Belridge properties. That is what he asked for. He didn't ask for it on the other properties. He wanted the portion of the gas cap on the Belridge property.

Q. (By Mr. Janes): Then as shown on this map and your markings, does [27] it show that——

Mr. Harkins: Just a moment. You asked him to shade in the contours of all Belridge property within that gas cap. Now, I observe the witness——

The Court: That is what I understood the question to be.

Mr. Harkins: The witness has drawn a line approximately showing the perimeter of the cap, but there hasn't been any shading in. Now, that is going to be quite an extensive operation because—if you want to go off the record——

The Court: No. Go ahead.

(Testimony of Roger F. White.)

Mr. Harkins: That is going to be quite an extensive operation because the Belridge properties are—the Main Property is considerably in the gas cap, the Tide Water is in and a few of the others, but you are going to have to shade in all up in here unless that can be understood that it is apparent from the record that where there is an indication of the word Belridge here without any parentheses, that indicates Belridge property. Where the word is "Belridge Result," that is also a Belridge property. The other properties of Richfield, Tide Water, Standard, Union and Texaco are also indicated by name.

Mr. Janes: I see. Thank you, counsel. [28]

Q. (By Mr. Janes): From this exhibit, does it appear that a large portion of the Belridge Result Property lies over the gas cap?

A. A part of the Result Property is included in the gas cap, yes.

Q. Did you ever do private consultation work for oil producers? A. Yes, for many years.

Q. In the course of your experience, were you asked at any time the value of a potential purchase by clients? A. Yes, many times.

Q. I will ask you, Mr. White, if it is not one of the main factors in determining the value of an oil property—is it not a fact that one of the main factors of value is the estimated oil reserve?

A. By one method of appraisal, yes.

Q. It is stipulated in this case, Mr. White, that as of September 1st, 1944, the Result Property had

(Testimony of Roger F. White.)

a total oil reserve of 389,596 barrels of oil. On that date the Result came into the ownership and control of taxpayer.

You have shown that Result Property, by the exhibit that you recently marked, overlays the gas cap to a considerable extent, is that not right?

A. That is right.

Q. It is stipulated, Mr. White, that on September 1st—on or about September 1st, 1944, taxpayer bought Result on a [29] time payment or production situation, and obligated itself, taxpayer, to pay for the property the cash value of 820,107 barrels of oil.

Now, speaking as an expert, and as a consultant for potential purchasers of oil property, if those are all the facts that you have concerning the value of the potential purchase, is it not fair to state, in your opinion, that unless that property had another factor of value in the—strike that.

With those facts, and assuming such a price was paid, would you not be of the opinion that the purchaser purchased the Result Property for a purpose other than the extraction of oil reserves thereunder?

Mr. Harkins: Your Honor, that is far beyond the province of the witness to answer. It would be calling for an opinion, not on value, but on the purpose behind the petitioner in making this—if that is intended as a hypothetical question to bring forward an opinion on value, it does not encompass material facts that have been stipulated, and I object to the question if it calls for a general conclusion of what the purpose of this petitioner was. I object

(Testimony of Roger F. White.)

to it if it is intended as a hypothetical question for extracting a value of the Result Property.

The Court: I am frank to admit I don't understand the question. Can you rephrase it? [30]

Mr. Janes: Yes, sir.

The Court: And then you can object again. Let me see if I can understand it, first. I can't rule on your objection until I do.

Mr. Janes: I could take little bits out of it, your Honor. Maybe that will do it better.

Q. (By Mr. Janes): You have shown that the Result Property overlies the gas cap to a large extent. Does that fact alone—and knowing that taxpayer owns considerable other portions of the field—does that fact alone give Result a value other than estimated reserves of oil? A. Certainly, yes.

Q. Why?

A. Well, because the gas—it has value if it is produced.

Q. Situated on the gas cap, what could a non-cooperating owner do to the detriment of other well owners on this field?

A. Well, he could bleed off the gas, of course. That is obvious.

Q. He could bleed off the gas. By that, what do you mean?

A. He could deplete the gas and destroy the natural physical propulsive power of the gas which might affect detrimentally the total ultimate future recovery of oil from [31] the property.

Q. When gas is bled off, as you stated, what hap-

(Testimony of Roger F. White.)

pens within the formation of the structure to either water or oil?

A. Well, you might have a shifting or a movement of the oil and/or the water. You might encourage infiltration of water. You might destroy some of the value in the field or in the property by reducing the probable or possible ultimate recovery of oil.

Q. As the gas is bled off then—looking at this field, this zone, the 64 Zone, as the gas might be bled off unrestrictedly through Result wells, that lessens the pressure in that zone causing the oil and water to move up structure, does it? A. Yes.

Q. And it could very well be detrimental to well owners by having oil which might momentarily be under their wells move away from them?

A. That is right. It might affect the migration of oil.

Q. It might affect the migration of oil?

A. That is right.

Mr. Janes: That is all.

Mr. Harkins: May I have a short recess? I don't believe I have any cross-examination, but I would like to consult with the engineer.

The Court: All right. I will just stay here. [32] We will have an informal recess.

(Short recess taken.)

Mr. Harkins: No cross-examination.

The Court: You may step down, Mr. White. Thank you.

(Witness excused.)

The Court: Does that conclude the case, gentlemen?

Mr. Janes: Yes.

Mr. Harkins: Yes.

The Court: Well, I would like seriatim briefs. How much time do you want for your original brief, Mr. Harkins?

Mr. Harkins: Could I have 60 days, your Honor?

The Court: All right. Sixty days for the original brief. Is 45 sufficient for you?

Mr. Janes: Yes.

The Court: Forty-five for yours in reply and 30 for your reply.

Mr. Harkins: Yes.

The Court: All right. We will stand in recess until 7:00 o'clock tonight.

(Whereupon, at 11:30 o'clock a.m., Wednesday, February 1, 1956, the hearing in the above-entitled matter was closed.)

Filed February 17, 1956, T.C.U.S. [33]

[Title of Tax Court and Cause.]

FINDINGS OF FACT AND OPINION

Filed March 29, 1957

Prior to February 1, 1950, petitioner and five other oil companies owned separate producing rights to an oil pool in Kern County, California, known as the 64 Zone. Prior to that date, the companies had engaged in unrestricted competitive production

of oil from the Zone. Petitioner owned two separate properties which overlay the Zone. On one, the Main Property, it had taken percentage depletion because it had already recovered its cost basis. It had taken cost depletion on the other, the Result Property, since that was higher than percentage depletion. Unrestricted competitive production had lowered the gas pressure in the Zone, and on February 1, 1950, the petitioner and the five other oil companies effected a unitization of their property interests in the Zone by an agreement under which each company was to receive a percentage share of total production from the Zone, which production was to be carried on by one company in behalf of all the participants to the agreement. Under the agreement, each participant retained the full right to sell, assign, or otherwise dispose of any of its property interests covered by the agreement, subject only to the production limitations imposed thereby. In computing its allowable depletion for 1950, petitioner allocated its share of unitized production to its Main and Result Properties, claiming percentage depletion on the former and cost depletion on the latter, as it had done in previous years. Respondent determined that the effect of the unitization agreement was a tax free exchange under section 112 (b) (1) by petitioner of its operating rights in its two separate properties covered by the agreement for a new depletable interest consisting of its share in unitized oil production, which determination had the effect of eliminating any cost depletion for the Result Property after unitization and thus reduced the

total amount of depletion claimed by petitioner on its share of unitized production. Held, petitioner did not exchange its interests in its two separate properties for a new depletable interest by participating in the unitization agreement, and it is entitled to claim percentage depletion on that part of unitized oil production attributable to its Main Property, and cost depletion on that part attributable to its Result Property. Held, further, the amount of unitized oil allocable to the two properties determined.

JOHN B. MILLIKEN, ESQ., and
HARRISON HARKINS, ESQ.,
For the Petitioner.

RICHARD W. JANES, ESQ.,
For the Respondent.

This proceeding involves a deficiency in income tax in the amount of $33,879.44 and a deficiency in excess profits tax in the amount of $9,866.88 for the year 1950. Petitioner claims an overpayment of taxes for such year.

The issues to be decided are: (1) Whether, by joining in a unitization agreement for the co-operative operation of all wells in a certain oil pool, petitioner exchanged its separate depletable interest in two oil properties covered by the agreement for a new depletable interest measured by its share of the total oil produced under unitized operation; and (2) if not, the amount of the cost depletion allowance

which it is entitled to deduct for one of its separate properties covered by the unitization agreement.

Some of the facts were stipulated.

Findings of Fact

The stipulated facts are so found and are incorporated herein by this reference.

Petitioner, a California corporation, filed its return for 1950 with the former collector of internal revenue at Los Angeles, California.

For many years petitioner has been engaged in the business of producing oil and gas from lands located in Kern County, California. In 1911, it acquired ownership in fee of some 30,845.96 acres, hereinafter referred to as the "Main Property." Two separate production fields, known as the North and South Belridge fields, were developed on that property. On September 1, 1944, petitioner purchased both the working interest and the landowners' and royalty owners' rights in a producing property known as the Result Property, consisting of 80 acres adjacent to the North Belridge field.

Oil and gas production from the North Belridge field is obtained from five different zones located at various depths. These are the Shallow Zone, which produces from relatively shallow depths; the Temblor Zone, whose approximate depth is 6,000 feet; the R. Zone, with an approximate depth of 7,000 feet; the 64 Zone, whose approximate depth is 8,000 feet; and the Y Zone, with an approximate depth

of 9,000 feet. The 64 Zone and the Temblor Zone also underlie portions of petitioner's Result Property.

The depletable interests here in issue are located in the 64 Zone. This zone is the largest developed oil and gas reservoir underlying petitioner's Main and Result Properties. It also underlies portions of adjacent and nearby land owned or operated by five other oil companies. The gas cap of the 64 Zone is located principally under petitioner's land, and oil can be moved up or down structure from petitioner's land by lessening or increasing the gas cap pressure.

Prior to October, 1941, production by petitioner and the five other oil companies operating in the 64 Zone was entirely on a competitive basis. By 1938, total oil production from the Zone reached approximately 12,000 barrels a day. Subsequent to 1938, the reservoir pressure and oil production from the Zone steadily declined. From some time in October, 1941, to April 1, 1947, a voluntary gas pressure maintenance program was put into effect by the companies producing from the Zone, and a portion of the gas produced from the Zone was returned to the reservoir. From April 1, 1947, until February 1, 1950, the six companies producing from the 64 Zone abandoned the program of voluntary pressure maintenance and resumed unrestricted competitive production.

During the period of unrestricted competitive production, April 1, 1947, to January 31, 1950, a

total of 3,255,417 barrels of oil were produced from the 64 Zone area. During the same period, petitioner produced 2,011,897 barrels from the 64 Zone from wells located on its Main Property, and 90,261 barrels from wells located on its Result Property.

On July 1, 1949, but effective as of February 1, 1950, petitioner and the five other oil companies producing from the 64 Zone entered into a unitization agreement which provided for the production of oil and gas from the Zone on a co-operative basis. The unitization agreement provided generally that the development and operation of all of the Participants' 64 Zone properties should be conducted by a designated operator with each Participant receiving an agreed upon percentage of all the oil, gas, and associated hydrocarbons produced.

Pertinent provisions of the agreement, are set forth below:

This Agreement * * * between the undersigned parties, each of whom is hereinafter called "Participant,"

Witnesseth:

* * *

Article I.

Definitions

Section 1. The following definitions shall apply to the following terms as employed in this agreement:

* * *

(c) Unitized Substances shall mean all oil, gas and associated hydrocarbons produced and saved from the 64 Zone pursuant to this agreement.

* * *

(e) Participant shall mean an owner at the date of this agreement, and each successor, assignee or transferee of such owner, of the right to develop and operate lands within the Area and to produce Unitized Substances, whether as lessee or otherwise, and shall include the owner of such lands not under lease as well as the lessee of such lands under lease.

* * *

(g) Tract Value shall mean that percentage which is the share of the Unitized Substances allocated under this agreement to each respective tract of land within the Area.

* * *

Article II.

Unitization-Conservation

Section 1. The rights of Participants to develop and operate in and to produce from the 64 Zone oil, gas and associated hydrocarbons, and the oil, gas and associated hydrocarbons in the 64 Zone and produced therefrom, are hereby unitized, to the end that the 64 Zone shall be developed and operated as a unit by a single operator for the benefit of Participants. The Tract Values set forth in the table attached hereto marked Exhibit "B" are hereby allocated to the respective tracts of land shown

therein. The Participating Equities set forth in the table attached hereto marked Exhibit "C" are hereby allocated to the respective Participants. The aggregate Tract Values of the lands of each Participant shall be equal, at all times, to the Participating Equity of such Participant. * * *

* * *

Section 3. * * * this agreement shall not apply to interests, rights or obligations in any formation, zone or stratum other than the 64 Zone. Each Participant reserves whatever rights it may have to develop and produce oil, gas and associated hydrocarbons from any and all formations, zones or strata other than the 64 Zone * * *.

* * *

Article V.

Transfers of Operating Rights and Other Property

Section 1. The initial Participants collectively are the owners on the date of this agreement of the right to develop and operate all lands within the Area and to produce Unitized Substances, and are the initial signatory parties to this agreement (exclusive of any exhibit hereto). At the effective time of this agreement Operator shall take exclusive possession of the operating rights of each Participant in and to the 64 Zone and enter into the performance of its duties hereunder; * * *.

* * *

Section 7. * * * Each Participant represents and warrants that as of the effective time of this agreement such Participant owns the unencumbered right to develop and operate the lands within the Area as to which it is a Participant and to produce Unitized Substances therefrom * * *.

* * *

Article VII.

Ownership of Unitized Substances, Unit Wells and Unit Facilities; Participation; Payment of Costs and Expenses

Section 1. Each Participant shall own the percentage of Unitized Substances equal to the Participating Equity of such Participant.

Section 2. The Participants shall own, as tenants in common, all Unit Wells and Unit Facilities, and each Participant shall own an undivided interest in the Unit Wells and Unit Facilities equal to the Participating Equity of such Participant.

Section 3. In the event of changes in Participating Equities pursuant to Article XI, the ownership of each Participant in Unitized Substances, Unit Wells and Unit Facilities shall change correspondingly.

Section 4. * * * If any numbered tract of land set forth in Exhibit "B" is now or hereafter becomes divided in ownership of Unitized Substances or Royalty Interest, or both, then, in the absence of an agreement between the interested parties deter-

mining the Tract Values of each segregated portion of such tract of land, the Tract Value shall be distributed to the segregated portions of such tract of land on a surface acreage basis, or if less than an entire numbered tract of land set forth in Exhibit "B" is excluded from this agreement as provided in Section 3 of Article XI, the Tract Value to be assigned to the portion of such tract of land remaining subject to this agreement shall be determined on a surface acreage basis.

* * *

Article VIII.

Disposition of Unitized Substances

Section 1. Each Participant shall accept its share of the Unitized Substances (other than gas or other Unitized Substances used for injection or in operations hereunder) currently in kind * * *.

* * *

Article X.

Payment of Rentals, Royalties and Taxes

Section 1. Each Participant shall pay all rentals, royalties, overriding royalties and other payments which pertain to or affect lands of such Participant subject to this agreement, including the 64 Zone, and which may be or become payable pursuant to any lease, operating agreement of other instrument to which such Participant is a party by privity of contract or privity of estate, and each Participant

shall promptly furnish to Operator, upon demand, a statement that payment thereof has been made. * * *

* * *

Article XI.

Assignments and Transfers; Rearrangement or Revision of Tract Values and Participating Equities

Section 1. Each Participant shall retain the right at any time or from time to time to sell, assign, transfer, quitclaim, surrender or otherwise dispose of, subject to this agreement, its interests, or any thereof, in whole or in part, in or to the lands or any thereof of such Participant in the Area and in or to the Unit Wells and Unit Facilities, provided that no interest in lands with respect to the 64 Zone shall be transferred or surrendered separate from a corresponding interest in Unit Wells and Unit Facilities, or vice versa. If an interest in lands with respect to the 64 Zone shall be transferred or surrendered, the transferee or person receiving such surrender shall be and become one of the Participants under this agreement, * * *.

Section 2. * * * If any numbered tract of land set forth in Exhibit "B" is divided, then, in the absence of an agreement between the interested parties determining the Tract Values of each segregated portion of such tract of land, the Tract Value shall be distributed to the segregated portions of such tract of land on a surface acreage basis.

* * *

Article XII.

Effective Time and Duration

Section 1. This agreement shall become effective at 7:00 o'clock a.m. on the first day of the first calendar month which commences not less than ten (10) days after all the following events shall have occurred:

(a) Execution of this agreement by all Participants listed in Exhibit "C."

(b) Execution of Lessors' and Royalty Owners' Consent, substantially in the form annexed hereto marked Exhibit "E," by at least ninety per cent (90%) in interest of the owners of Royalty Interests under each tract of land with respect to which a Participant has executed this agreement, unless all Participants shall otherwise agree in writing.

(c) Approval of this agreement by the Oil and Gas Supervisor of the State of California, pursuant to the provisions of Section 3301 of the Public Resources Code of the State of California, on the form of "Approval and Determination" annexed hereto marked Exhibit "F."

Section 2. This agreement * * * shall continue in full force and effect as long as Unitized Substances, or any of them, can be produced from the 64 Zone in quantities determined by Participants to be sufficient to pay to produce; provided, however, that this

agreement may be terminated prior to such expiration date by the unanimous consent of all Participants.

* * *

Article XIII.

Miscellaneous

* * *

Section 3. It is the intention of each Participant to establish Operator as its agent under this agreement, for the sole purpose of developing, operating and protecting its interest in the 64 Zone to the extent herein set forth.

The Participants in the unitization agreement and their respective "Participating Equities" were as follows:

Participant	Participating Equity and Tract Value Assigned
Belridge Oil Company	71.87%
Tide Water Associated Oil Company	16.58%
Richfield Oil Corporation	4.44%
The Texas Company	4.44%
Standard Oil Company of California	1.48%
Union Oil Company of California	1.19%

The tracts of Belridge, Tide Water, Richfield, Standard, and one of the three tracts of Union were held in fee by such companies. The tracts of the Texas Company and two of the three tracts of the Union Oil Company were leaseholds. The participating equities allotted to the parties appproximated

the percentages of the total production from the 64 Zone which each of the respective parties had obtained during the period of unrestricted competitive production which immediately preceded the effective date of the agreement.

The agreement further provided that each Participant was obligated to pay a part, equal to its participating equity, of all costs and expenses of the unit operation.

Petitioner was designated as the original Operator and has continued to act as such. The agreement provided that all matters relating to the removal of the Operator and the selection of a successor Operator should be determined by the agreement of not less than three Participants representing, in the aggregate, not less than 80 per cent of the participating equities.

On January 17, 1950, the Participants agreed, as provided in Article XII, Section 1 (b), that the unitization agreement would become effective at 7:00 a.m., February 1, 1950, despite the fact those holding lessors' and royalty owners' interests in 90 per cent of the land covered by the agreement had not executed consents to the agreement.

A number of the lessors and royalty owners who possessed interests in the 64 Zone covered by the leases held by The Texas Company and the Union Oil Company executed consents to the agreement, and those companies endorsed their acceptance of such consents.

Petitioner, Tide Water, Richfield, and Standard, all of whom were Participants under the agreement, and who together owned in fee, 92 per cent of the land covered by the agreements, did not execute lessors' and royalty owners' consents.

The portions of petitioner's two properties affected by the unitization agreement were the 64 Zone underlying its Result Property and the 64 Zone underlying some, but not all, of its Main Property. It did not affect any of the other zones underlying petitioner's land. Petitioner and the other five Participants continued to operate and produce from one or more of the other zones underlying the same surface area of their respective properties as were covered by the agreement. Petitioner took no production from the Temblor Zone of its Result Property during the years 1949 to 1953, inclusive, but in 1954, it resumed production from the Temblor Zone.

Under unitized operation in 1950 (February 1 through December 31), a total of 428,139 barrels of oil were produced from the 64 Zone—21,672 barrels from wells located on petitioner's Result Property, 215,390 barrels from wells located on its Main Property, and 191,077 barrels from wells located on the properties of other Participants. Petitioner's 71.87 per cent share of total production was 307,704 barrels.

Prior to 1950, petitioner had completely recovered its tax basis for its Main Property through cost depletion allowances, and therefore computed its

allowable depletion deduction on the statutory percentage of income. For its Result Property, depletion based on adjusted cost has consistently been greater than depletion based on the statutory percentage of income.

On its return for 1950, petitioner claimed cost depletion on its Result Property and percentage depletion on its Main Property, as it had done in previous years. It computed cost depletion on the Result Property for the month of January on the basis of the actual number of barrels of oil taken from wells located on that property during such month. To arrive at the number of barrels of oil which it claimed were attributable to its Result Property from its share of total unitized oil produced during the remainder of the year, it determined the ratio of production from the 64 Zone of that property in 1949 to its total 64 Zone production during that year and applied that ratio to the total 64 Zone production allotted to it under unitized operation for 1950. The remainder of the oil received from unitized production was added to its individual production from its Main Property and percentage depletion was claimed on the total. Petitioner thus claimed cost depletion on the Result Property in the amount of $72,010.63, and percentage depletion on its Main Property of $1,568,662.93.

On its return for 1950, petitioner reported the adjusted cost of Result, as of January 1, 1950, to be $689,863.29, and used a cost basis of $3.43035 a

barrel in computing cost depletion. Petitioner claimed an increased cost in its petition, and the parties agree that the cost basis was $1,007,976.81 on January 1, 1950, and that such basis increased by an additional $8,886.29 prior to the end of the year. They also agree that the remaining oil reserves of the property were as follows:

	Barrels of Oil		
Remaining Reserve on	64 Zone	Tremblor Zone	Total
January 1, 1950	177,308	23,798	201,106
January 31, 1950	173,978	23,798	197,776

Respondent determined that, by virtue of the unitization agreement, petitioner made nontaxable exchanges on February 1, 1950, of its two separate interests in the 64 Zone for a single depletable interest therein, consisting of its 71.87 per cent undivided interest in the properties covered by the agreement. He determined that petitioner's basis for such undivided interest was the combined adjusted bases of its separate interests in the 64 Zone, and that the statutory percentage depletion allowable thereon would give it the maximum depletion allowance. He disallowed $56,888.79 of the depletion deduction claimed by petitioner on its return, as follows: Petitioner's computation of percentage depletion on its Main Property was revised by excluding from the Main Property, for the period February 1, 1950, to December 31, 1950, the production from the 64 Zone unitized area of the property; cost depletion on the Result Property for the month of January, 1950, was computed and allowed on a cost basis of $1,007,976.81; since no pro-

duction was obtained from the other producing zone of Result during 1950, no additional cost depletion was allowed for that property for the period February 1 to December 31, 1950; percentage depletion in the amount of $278,668.82 was allowed for petitioner's 71.87 per cent undivided interest in the unitized properties. No computation of cost depletion with respect to that 71.87 per cent undivided interest appears in the deficiency notice.

The petitioner, aside from the claim of overpayment made in its petition, did not file a refund claim for the year in issue; and no part of the income and excess-profits taxes of $1,019,485.40, paid by it for such year, has been refunded or otherwise credited to it.

Petitioner paid a $203,897.08 installment of its 1950 taxes on December 7, 1951, which amount was paid within two years before the November 2, 1953, execution by the petitioner and the respondent of the extension agreement pursuant to section 276 (b) of the 1939 Code; and such agreement was executed within three years from May 5, 1951, the date the petitioner filed its tax return for 1950.

Opinion

Rice, Judge:

The consolidation of oil producing properties under centralized production management, commonly referred to as unitization, is a conservation program to effect the most economical and productive extraction of oil, gas, and associated hydrocar-

bon products from a given oil or gas field. Unitization may be effected by voluntary agreement of the separate owners of oil and gas properties and interests, or, in some states, by compulsory action of duly authorized state authority.

When voluntary unitization is effected, it may be done by means of a community lease in which several land owners, each owning separate tracts of land, join in a single oil or gas lease describing and granting, for development purposes, the entire area owned by them to a single developer. It may also be effected by the lessees of oil development rights whose leases give them the express consent of the lessors to develop the leased property under unitized operation; or, unitization may be effected by a separate unitization agreement among oil producers such as the one before us here. The participants in the unitization agreement here were fee holders or lessees, each of whom, however, had the exclusive right to develop the 64 Zone oil pool beneath its respective surface area of land.

Prior to the effective date of the agreement, petitioner held two separately depletable oil producing properties. On one, the Main Property, it had completely recovered its tax base and was claiming percentage depletion. On the other, the Result Property, it was claiming cost depletion. After unitization, it claims that it is still entitled to claim percentage depletion on that part of its share of unitized oil attributable to its Main Property, and cost depletion on that part of its share of unitized oil attributable to the Result Property.

By claiming both cost and percentage depletion on the respective shares of unitized oil which it attributes to the two properties, petitioner arrives at a greater depletion deduction than the respondent's determination would allow, since he permitted only the statutory percentage depletion on all of petitioner's share of unitized oil. No issue is raised as to petitioner's having a depletable economic interest in unitized oil production, but only as to the method it used in computing depletion on such production.

The respondent contends that the effect of the unitization agreement here was a tax free exchange by petitioner of its oil producing rights in the 64 Zone pool underlying its Result Property, and that part of its Main Property subject to the agreement, for a new and separate depletable economic interest consisting of and measured by its 71.87 per cent share of oil produced under unitized operation of the field. Section 112 (b) (1)[1] provides, in sub-

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[1]Sec. 112. Recognition of Gain or Loss.

* * *

(b) Exchanges Solely in Kind—

(1) Property held for productive use or investment—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

stance, that no gain or loss shall be recognized if property held for productive use in a taxpayer's trade or business is exchanged solely for property of a like kind to be held for a like purpose. To uphold the respondent's determination, we must find that the unitization agreement here, preferably both in form and in substance, effected an exchange; and, if not in form, certainly in substance.

Our examination of the unitization agreement discloses no words of conveyance. The key provision of the agreement by which unitization was effected is found in Article II, Section 1, as follows:

> The rights of Participants to develop and operate in and to produce from the 64 Zone oil * * * are hereby unitized, to the end that the 64 Zone shall be developed and operated as a unit by a single operator for the benefit of Participants.

Article V, Section 1, provided that at the effective date of the agreement, the Operator should take exclusive possession of the operating rights of each Participant and was to enter into the performance of his duties. Article VII, Section 1, provided that each Participant should own the percentage of unitized substances equal to its participating equity, and Article VIII, Section 1, provided that each Participant should accept its share thereof currently in kind. Article XI, Section 1, retained for each Participant the full right to sell, assign, transfer, quitclaim, surrender, or otherwise dispose of its interest in any land covered by the agreement,

subject only to the production limitations imposed thereby. Neither in those provisions of the agreement, nor elsewhere, do we find any words of conveyance; and, more important, we find no intention on the part of the Participants to convey or exchange their economic interests in the 64 Zone. We recognize that the agreement provided that all wells and production equipment used by the Operator were to be held by the Participants as tenants in common. But that joint ownership was only of depreciable equipment and certainly not of the depletable economic interests and rights to drill and produce oil from the land.

We think the net effect of what the Participants to the agreement accomplished was the creation and organization of a consolidated production operation for the extraction of their respective shares of oil from the whole pool in which they held separate operating rights. The purpose which prompted the execution of the agreement in question was the recognition on the part of the Participants that unrestricted competitive production from the Zone was causing a lowering of the gas pressure and would eventually result in possible serious underground waste of oil, gas, and associated hydrocarbon products. For a period of some 5½ years prior to April 1, 1947, the Participants had maintained a voluntary gas pressure program whereby a portion of the gas produced from the Zone was returned to the reservoir. We think the unitization agreement here was nothing more than another joint effort on the

part of the owners of the producing rights to the Zone to best conserve their respective individual interests therein by joining in a plan for the most economical and productive operation of the whole field. Hence, we think each Participant had exactly the same interests and rights in its respective properties after unitization as before, except that by mutual consent they had agreed to limit their production and operate their wells in the most economically feasible way from the standpoint of conservation considerations.

The statute specifically gives a taxpayer, who owns a depletable economic interest in oil, which all concede the petitioner here had, an election to deplete its interest on the basis of the statutory percentage amount provided in section 114 (b) (3), or by recovering its cost basis, whichever is greater. It seems to us that the respondent's determination here would deprive petitioner of the just due given it by the express terms of the statute.

Having concluded that petitioner retained its original separate depletable economic interests in the 64 Zone, we turn now to the question of the exact amount of cost depletion which it is entitled to claim on the Result Property. As noted in our findings of fact, it computed such cost depletion on its return by allocating a portion of its share of the unitized oil production to that property on the basis of the ratio of its production from such property in 1949 to its total 64 Zone production during that year and then added such allocated amount to the

actual production for the month of January, 1950. On brief, petitioner argues that the allocation of a portion of its share of unitized oil production should be made on the basis of the ratio of actual Result production from the 64 Zone during the period of unrestricted competition preceding the effective date of the agreement to the total 64 Zone oil production during such period by all producers.

The respondent insists that even if we uphold the petitioner's position with respect to its having a depletable interest in two separate oil producing properties both before and after unitization, as we have done, no allocation of unitized oil production can be made to the Result Property because of the mechanics involved in the computation of cost depletion. He argues that in computing cost depletion, actual production from the property each year must be subtracted from the estimated reserve at the beginning of the year.[2] He points out that under unitized operation from February 1 to December 31, 1950, some 21,672 barrels of oil were actually produced from wells located on the Result Property. He argues further that under petitioner's theory of allocation, a lesser number of barrels (11,859) would be allocated to that property, and concludes that under such plan of allocation, the estimated total reserves at the beginning of the period would, in fact, be exhausted long before petitioner's theoretical cost depletion would indicate because the total production from wells on the Result Property,

[2]Regulations 111, Sec. 29.23(m)-2.

rather than an allocated portion, must be subtracted each year in arriving at the remaining oil reserve.

We do not agree with this argument. It seems to us that the simple answer to the respondent's objection is that oil taken from the 64 Zone through wells located on the Result Property, in excess of the allocation which petitioner contends should be made, must be deemed to be oil from other areas in the pool made possible only by the unitization agreement.

Insofar as petitioner's plan of allocation suggested on brief is concerned, we think it is in substantial accord with the agreement between the Participants. The parties stipulated that each Participant's share in unitized production was based on the production record of the various properties subject to the agreement during the period of unrestricted competitive production prior to the effective date of the agreement. And while the agreement does not allocate a share of total unitized production individually to petitioner's Main and Result Properties, we think that it was clearly the intent of the participants that petitioner's total share was allocated on the basis of its previous production from those two properties. We therefore conclude that the ratio which 90,261 barrels bears to 3,255,417 barrels (total Result 64 Zone production and total 64 Zone production April 1, 1947, to February 1, 1950), or 2.77 per cent, multiplied by the total production from the Zone under unitized operation

during 1950 of 428,139 barrels, or 11,859 barrels, are the proper number of barrels allocable to the Result Property for the period February 1 to December 31, 1950.

Decision will be entered under Rule 50.

Entered March 29, 1957.

Served March 29, 1957.

[Title of Tax Court and Cause.]

COMPUTATION FOR ENTRY OF DECISION

The attached computation reflecting a deficiency in income tax in the amount of $1,246.97 for the taxable year 1950 is submitted on behalf of the respondent in compliance with the opinion of the Court determining the issues in this proceeding.

The computation is submitted without prejudice to the respondent's right to contest the correctness of the decision entered herein by the Court pursuant to the statute in such cases made and provided.

/s/ NELSON P. ROSE, R.E.M.
Chief Counsel Internal Revenue Service.

Of Counsel:

MELVIN L. SEARS,
Regional Counsel;

E. C. CROUTER,
Assistant Regional Counsel;

R. E. MAIDEN, JR.,
Special Assistant to the Regional Counsel;

RICHARD W. JANES,
Attorney, Internal Revenue Service.

Without prejudice to the right of appeal, it is agreed that the attached computation is in accordance with the opinion of the Tax Court in the above-entitled proceeding.

/s/HARRISON HARKINS,
Counsel for Petitioner.

Ap:LA:AA-EWM

Recomputation Statement

July 8, 1957.

In re: Belridge Oil Company
601 West Fifth Street, Room 815
Los Angeles 17, California

Docket No. 54288

Income Tax

Year	Liability	Assessed	Deficiency
1950	$1,020,732.37	$1,019,485.40	$1,246.97

The recomputation of tax liability shown herein is in accordance with the opinion of the Tax Court of the United States filed March 29, 1957, for decision to be entered under Rule 50.

Year 1950

Adjustment to Net Income

	Income Tax Net Income	Excess Profits Net Income
Net income as disclosed by the deficiency notice dated May 28, 1954	$2,350,549.01	$2,247,054.97
Additional deduction:		
(a) Depletion	74,399.32	74,399.32
Net income as adjusted	$2,276,149.69	$2,172,655.65

Explanation of Adjustment

(a) Net income is decreased $74,399.32, representing adjustment of deduction for depletion computed as follows:

Depletion allowed in deficiency notice:		
Cost depletion allowed on result property for the month of January	$ 16,690.52	
Percentage depletion allowed	1,567,094.25	$1,583,784.77
Revised depletion allowance:		
Cost depletion allowed on result property as computed in Exhibit B, attached	$ 76,800.96	
Percentage depletion allowed on Belridge property for the year, as computed in Exhibit A, attached	1,581,383.13	1,658,184.09
Additional depletion allowance		$ 74,399.32

Computation of Tax

Income Tax

	Tax at Ordinary Rates	Alternative Tax
Income tax net income	$2,276,149.69	$2,276,149.69
Less: Net long-term capital gain		103,494.04
Surtax net income	$2,276,149.69	$2,172,655.65

	Tax at Ordinary Rates	Alternative Tax
Combined normal tax and surtax:		
$2,276,149.69 at 42% minus $4,750.00	$ 951,232.87	$ —
$2,172,655.65 at 42% minus $4,750.00		$ 907,765.37
Add: 25% of net long-term capital gain		25,873.51
Tax at ordinary rates	$ 951,232.87	$ —
Alternative tax (lesser tax)		$ 933,638.88
Income tax		$ 933,638.88

Excess Profits Tax

Excess profits tax net income		$2,172,655.65
Less: Excess profits credit per deficiency notice		1,596,765.67
Adjusted excess profits net income		$ 575,889.98
(1) 30% of $ 575,889.98		$ 172,766.99
(2) 62% of $2,172,655.65	$1,347,046.50	
Less: Combined normal tax and surtax on $2,172,655.65	907,765.37	$ 439,281.13
Excess profits tax (lesser of (1) or (2)		$ 172,766.99
Proration of excess profits tax 184/365 of $172,766.99		$ 87,093.49
Income tax from above		$ 933,638.88
Excess profits tax from above		87,093.49
Income tax liability		$1,020,732.37
Income tax assessed: Original return, Account No. 4180941, Los Angeles District		1,019,485.40
Deficiency in income tax		$ 1,246.97

	tal ridge perty	Gas & E.P.C.	Other	Overhead	Total
ross	3,769.62	$575,638.00			$6,398,467.33
per					
ans					
Cou					
Res					
Zon					
par	6,714.50				
	0,484.12	$575,638.00			$6,398,467.33
ross					
ther	3,586.40)	(179.77)	$401,960.42	$ 1,842.12	362,872.53
otal	1,897.72	$575,458.23	$401,960.42	$ 1,842.12	$6,761,339.86
xper					
D					
	8,560.17	$205,763.16			
	4,912.53	338,039.58			
	0,740.21	15,313.06			
	2,090.61	106,194.23			
	(116.13)				
ota	6,187.39	$665,310.03			$1,938,605.75
ran	0,752.40	(104,791.05)			
epr	9,808.82	107,739.97			505,167.31
ran	4,957.80	(15,557.38)			
nor		4,487.33			4,487.33
ban	8,453.77				18,453.77
			$ 6,012.08		6,012.08
oss			8,620.35		8,620.35
ona			2,350.00		2,350.00
ota	0,160.18	$657,183.90	$ 16,982.43		$2,483,696.59
ver				$342,768.21	342,768.21
(a	8,795.13	90,376.93		(312,582.33)	
(b	8,361.16	11,646.62		(30,185.88)	
	1,289.41)	(532.61)		$ 1,842.12	
ota	6,027.06	$758,679.84	$ 16,982.43	$ 1,842.12	$2,826,480.80
et	5,870.66	$(183,221.61)	$384,977.99	None	$3,934,875.06
0%	2,935.33	$ (91,610.81)	192,489.00	- -	
7%	1,383.13	158,300.45	None		
llo	1,383.13	None	None	- -	

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	Total Belridge Property	Gas & L.P.G.	Total
	$1,256,187.39	$665,310.03	$1,938,605.75
	100,752.40	(104,791.05)	-
	$1,356,939.79	$560,518.98	$1,938,605.75
	69.996%	28.913%	100%
	$ 218,795.13	$ 90,376.95	$ 312,582.33
	$ 239,216.20	$205,763.16	$ 446,319.91
	32,266.68	(33,560.09)	-
	$ 271,482.88	$172,203.07	$ 446,319.91
	60.827%	38.583%	100%
	$ 18,361.16	$ 11,646.62	$ 30,185.88

Belridge Oil Company

EXHIBIT B

Computation of Cost Depletion on Result Property for the Period January 1, 1950, Through December 31, 1950

Basis for depletion of Result property at January 1, 1950, as shown by the stipulation of facts	$1,007,976.81	
Add: Additional Cost of Result property due to increase in selling price of crude oil during the period January 1, 1950, through December 31, 1950	8,886.29	
Basis for depletion of Result property at January 1, 1950	$1,016,863.10	
Estimated reserve at January 1, 1950, as per stipulation of facts		201,106 barrels
Cost per barrel	$	5.0563538
Production from Result property for the month of January, 1950, as shown by the stipulation of facts		3,330 barrels
Production from Result property for the period February 1 through December 31, 1950, as per the opinion of the Tax Court of the United States		11,859 barrels
Total production for the year 1950		15,189 barrels
Allowable Cost depletion on Result property for the period January 1 through December 31, 1950	$	76,800.96

Received and filed July 24, 1957, T.C.U.S.

Tax Court of the United States

Docket No. 54288

BELRIDGE OIL COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion filed March 29, 1957, the respondent filed a computation for entry of decision on July 24, 1957. The petitioner having acquiesced therein, it is

Ordered and Decided: That there is a deficiency in income tax for the taxable year 1950 in the amount of $1,246.97.

/s/ J. MURDOCK,
Judge.

Entered July 26, 1957.

Served July 29, 1957.

Entered July 29, 1957.

[Title of Tax Court and Cause.]

T. C. Docket No. 54288

PETITION FOR REVIEW

To the Honorable Judges of the United States Court of Appeals for the Ninth Circuit:

The Commissioner of Internal Revenue petitions the United States Court of Appeals for the Ninth Circuit to review the decision of The Tax Court of the United States, entered in this case on July 26, 1957, pursuant to its opinion filed March 29, 1957 (27 T.C... No. 128), ordering and deciding "That there is a deficiency in income tax for the taxable year 1950 in the amount of $1,246.97."

This petition for review is taken pursuant to the provisions of Sections 7482 and 7483 of the Internal Revenue Code of 1954.

Jurisdiction

The respondent on review, Belridge Oil Company, is a California corporation, with offices in Los Angeles, California, and filed its Federal income tax and excess profits tax return for the taxable year 1950, the year involved herein, with the former Collector (now District Director) of Internal Revenue for the Sixth District of California, whose office is located at Los Angeles, California, which collection district is within the jurisdiction of the United States Court of Appeals for the Ninth Circuit, wherein this review is sought.

Nature of Controversy

Prior to February 1, 1950, taxpayer and 5 other oil companies owned separate producing rights to an oil pool in Kern County, California, known as the 64 Zone. Prior to that date, the companies had engaged in unrestricted competitive production of oil from the Zone. Taxpayer owned two separate properties which overlay the Zone. On one, the Main Property, it had taken percentage depletion because it had already recovered its cost basis. It had taken cost depletion on the other, the Result Property, since that was higher than percentage depletion. Unrestricted competitive production had lowered the gas pressure in the Zone, and on February 1, 1950, the taxpayer and the 5 other oil companies effected a unitization of their property interests in the Zone by an agreement under which each company was to receive a percentage share of total production from the Zone, which production was to be carried on by one company in behalf of all the participants to the agreement. Under the form of the agreement, each participant retained the full right to sell, assign, or otherwise dispose of any of its property interests covered by the agreement, subject only to the production limitations imposed thereby. In computing its allowable depletion for 1950, taxpayer allocated its share of unitized production to its Main and Result Properties, claiming percentage depletion on the former and cost depletion on the latter, as it had done in previous years.

The Commissioner determined that the effect of the unitization agreement was a tax-free exchange

under Section 112(b)(1) by taxpayer of its operating rights in its two separate properties covered by the agreement for a new depletable interest consisting of its share in unitized oil production, which determination had the effect of eliminating any cost depletion for the Result Property after unitization and thus reduced the total amount of depletion claimed by taxpayer on its share of unitized production.

The Tax Court held that taxpayer did not exchange its interest in its two separate properties for a new depletable interest by participating in the unitization agreement, and it is entitled to claim percentage depletion on that part of unitized oil production attributable to its Main Property, and cost depletion on that part attributable to its Result Property.

The issue to be presented for review therefore is: Whether the Tax Court erroneously held that by joining in a unitization agreement for the co-operative operation of all the wells in a certain oil pool, taxpayer did not exchange its separate depletable interest in two oil properties covered by the agreement for a new depletable interest measured by its share of the total oil produced under the unitized operation and is, accordingly, entitled to claim percentage depletion on one and cost depletion on the other as previously claimed by taxpayer.

Although there are no words of conveyance in the agreement involved that each participant retained full right to sell, assign, etc., subject only to the

production limitations imposed by the agreement, and there was no expressed intention on the part of the participants to convey or exchange their economic interest in the Zone, the Supreme Court in many cases has fully prescribed and applied the theory that its "decision did not turn upon the particular instrument involved, or upon the formalities of the conveyancer's art, but rested upon the practical consequences of the provision for payments of that type."

It is the position of the Commissioner that the practical consequence of the transaction here, whereby the unitization was accomplished, was exactly the same as though formal contracts of exchange had been executed and, therefore, his treatment of the transaction is the same as prescribed by the Supreme Court. Furthermore, the practical consequence of a unitization agreement is, therefore, that the owner of a larger interest in a small property which has been exchanged for a smaller interest in a larger property no longer looks to the production from the well or wells on his original property but does look to all the wells on a unitized block.

It is, therefore, presented that The Tax Court erred in its holdings herein.

Assignments of Error

The errors upon which the Commissioner relies in this proceeding will be separately filed and served in due course as permitted and provided by the Rules of this Court.

Wherefore, it is prayed that this Honorable Court review the matters set forth herein and to be specifically assigned as error, and correct the errors and reverse the decision of The Tax Court of the United States.

/s/ CHARLES K. RICE, C.A.R.
Assistant Attorney General;
/s/ NELSON P. ROSE, C.A.R.
Chief Counsel Internal Revenue Service, Counsel for Petitioner on Review.

Of counsel:

C. R. MARSHALL,
Special Attorney
Internal Revenue Service.

Received and filed October 18, 1957, T.C.U.S.

[Title of Court of Appeals and Cause.]

T. C. Docket No. 54288

STATEMENT OF POINTS TO BE RELIED UPON

The Commissioner of Internal Revenue submits the following Statement of Points upon which he intends to rely as the basis of the petition for review:

That the Tax Court of the United States erred:

1. In failing to hold and decide that taxpayer, as a participant in the unitization agreement, contributed separate operating interest in the 64 Zone in

10. In that its opinion and decision are contrary to the law and the regulations promulgated thereunder and are not supported by substantial evidence of record.

11. In holding and deciding that there is a deficiency in income tax for the year 1950 only in the amount of $1,246.97.

12. In failing to hold and decide that there is a deficiency in income tax for the year 1950 in the amount of $33,879.44 and a deficiency in excess profits tax of $9,866.88.

/s/ CHARLES K. RICE, C.A.R.,
Assistant Attorney General.

/s/ NELSON P. ROSE, C.A.R.,
Chief Counsel Internal Revenue Service, Counsel for Commissioner of Internal Revenue.

Affidavit of service by mail attached.

Received and filed December 16, 1957. T.C.U.S.

[Title of Tax Court and Cause.]

CERTIFICATE OF CLERK

I, Howard P. Locke, Clerk of the Tax Court of the United States, do hereby certify that the foregoing documents, 1 to 28, inclusive, constitute and are all of the original papers on file in my office as called for by the "Designation of Contents of Record," except the original exhibits which are sepa-

rately certified, in the case before The Tax Court of the United States docketed at the above number and in which the respondent in The Tax Court has filed a petition for review as above numbered and entitled, together with a true copy of the docket entries in said Tax Court case, as the same appear in the official docket of my office.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 31st day of December, 1957.

[Seal] /s/ HOWARD P. LOCKE,
Clerk, Tax Court of the
United States.

[Endorsed]: No. 15887. United States Court of Appeals for the Ninth Circuit. Commissioner of Internal Revenue, Petitioner, vs. Belridge Oil Company, Respondent. Transcript of the Record. Petition to Review a Decision of The Tax Court of the United States.

Filed February 14, 1958.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for the Ninth Circuit.